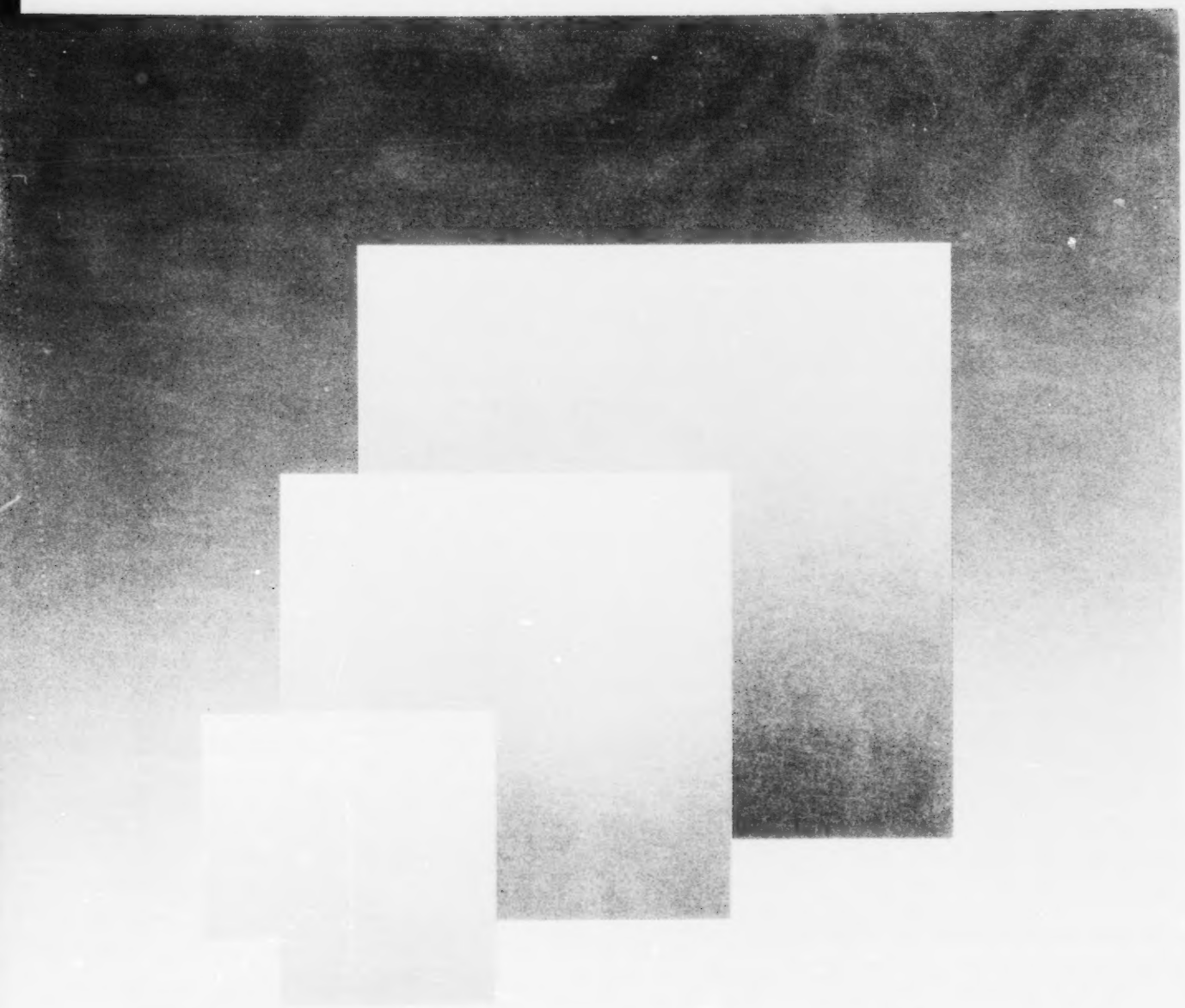

# Managing Adjustment
## Policies for Trade-Sensitive Industries

A Statement by the Economic Council of Canada
1988

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This Statement reflects the views of the Members of the Economic Council of Canada; however, comments by Raymond Koskie appear at the end of the document.

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# Foreword

The postwar period has been marked by significant liberalization and expansion of world trade. This development has been greatly facilitated by the General Agreement on Tariffs and Trade, which has served as the instrument for liberalizing the rules governing international trade. Thus tariffs on manufactured trade fell, on average, from 40 per cent in 1947 to between 5 and 6 per cent in 1987. The growth and liberalization of trade have not been without problems, however. One of those problems has been the difficulty occasionally experienced by workers, firms, industries, regions, and/or governments in adjusting to increased openness to trade. That difficulty seems to have increased in the 1970s and 1980s, with the advent of less favourable economic performance in the industrialized world, strong new competitors among the newly industrialized countries, and the acceleration of technological change. Indeed, a leading trade commentator (John H. Jackson) suggested recently that "perhaps the most substantial and fundamental policy problem of international trade today is the question of adjustment." It is to that topic that we direct our attention in this Statement.

Here we bring together the principal conclusions of nearly two years' work on adjustment in the manufacturing sector. The Council's researchers have been able to quantify the changes that are taking place regularly in the labour market, linking, for the first time, the growth and decline of firms with what is happening to jobs. As a result, we now have complementary sets of data on the rates of job and worker turnover. The volume of change is impressive. At least 30 per cent of the jobs that existed in 1971 had disappeared by 1981 because of plant decline and closure, while the number of jobs gained as a result of plant expansion and openings was substantially higher. Furthermore, the indicators of job and worker turnover were just as high in the trade-sensitive industries – textiles, clothing, and knitting, in particular – as they were in manufacturing as a whole.

Despite this track record of mobility, there is a widespread belief that Canadian firms and their employees resist change. The surge in entrepreneurship that we are witnessing in Quebec, and the favourable reaction in that province to a bilateral trade accord, suggest that this resistance may sometimes be overestimated. But there are undoubtedly real fears that unfettered competitive pressures will lead to plant closures and long spells of unemployment. In some cases these fears are well founded, and that explains, in part, why governments are often called upon to intervene.

Over the past 15 years, governments have responded to such fears by adopting special policies to support such manufacturing industries as shipbuilding, textiles, automobiles, and others. The Council has examined several of these sectoral policies during the course of this study and, in general, has found them wanting.

We recognize, however, that governments cannot ignore the anxieties of Canadians about the process of adjustment. In this Statement, we set out a simple framework designed to help in understanding the reactions of firms and workers to adjustment pressures and the

consequent calls for government action. Then, on the basis of our research findings, we put forward nine principles, in the form of recommendations, to guide governments in developing policies for trade-sensitive industries. These are supplemented by a number of suggestions for improvements in existing labour adjustment programs.

The detailed findings underlying the conclusions summarized in this Statement are being published in a companion research report, while the various case studies prepared for the project will be released during the coming months.

I would like to take this opportunity to thank the members of the Council's Advisory Committee on Firm Adjustment to Trade, and in particular its chairman, Graham Wilson. The committee met three times to discuss drafts of the findings summarized here and to review the recommendations. Individual members of the committee also gave generously of their time in consultations with the research team.

Judith Maxwell
Chairman

# Managing Adjustment

## READER'S NOTE

The reader should note that conventional symbols similar to those used by Statistics Canada have been used in the tables:

.. figures not available
e estimated figures.

Details may not add up to totals because of rounding.

# 1 An Overview

Canada's prosperity depends on trade, and the data indicate that the manufacturing sector produces two-thirds of the goods and services that we export. Yet industrial countries like Canada face a constant challenge to renew their products and their production systems in order to meet the pressures of international competition.

To be competitive in today's global marketplace, Canada must manage the adjustment to change by manufacturing firms and workers wisely. In managing adjustment, Canadians are trying to channel capital investment, managerial talent, and workers' skills into activities where they will be most productive.

This constant renewal process is unquestionably a sensitive social issue, for we are talking about reallocating capital and people changing jobs. People, quite naturally, tend to resist the hardships associated with these kinds of adjustment. What is surprising, and encouraging, is that our research shows that Canadians are very adaptable and that there is an impressive amount of adjustment taking place in the manufacturing sector on an ongoing basis.

The purpose of this study is not only to assess the amount of change that is taking place but also to examine the appropriate role for governments in fostering adjustment and in moderating its more painful side effects.

The fact that so much adjustment has been taking place is a reflection of the competitive challenges faced by Canadian manufacturing over the past 20 years.

- The newly industrialized countries (NICs) have undercut traditional industries – textiles, clothing, and footwear, in particular. At the same time, the dynamic Japanese economy has displaced some Canadian production of goods such as automobiles, ships, and electrical appliances.

- Rapid technological change has been putting constant pressure on Canadian firms to adopt newer technology in order to keep up with foreign rivals and has forced workers to retrain or otherwise acquire new skills.

- Changes in transportation have also put pressure on Canadian manufacturers. The falling cost of transportation, combined with easier access to labour in Third World countries, have provided opportunities to locate plants abroad or to subcontract operations to foreign firms.

- At the same time, the deregulation of the railway, trucking, and airline industries in the United States in the late 1970s and early 1980s threatened to place large users of transportation services in Canada at a competitive disadvantage relative to their U.S. counterparts. Thus they were led in turn to put pressure on the Canadian government to deregulate the transportation sector in this country.

- Fluctuations in the exchange rate have affected Canada's competitiveness vis-à-vis its major industrial competitors and have forced manufacturers to take foreign exchange markets into account in their everyday decisions.

- The trebling of the world price of oil in 1973-74, its subsequent doubling in 1978-79, and, more recently, its substantial decline have placed considerable pressure on Canadian producers to use more-flexible, fuel-efficient methods of production in order to compete internationally.

- Finally, the decline in tariffs under the General Agreement on Tariffs and Trade (GATT) under the *Kennedy Round* (1966-70) and the *Tokyo Round* (1979-87) has increased import competition for Canadian producers because the prices of imports have fallen; at the same time, however, it has provided opportunities for exporters by giving them greater access to foreign markets.

In the past, the debate on adjustment policy in Canada tended to focus on the particular problems of a particular industry; but recently two factors have forced us to address the issue from a broader perspective. First, the negotiation of a Canada-U.S. Free-Trade Agreement has awakened many Canadians to the scope of the adjustment challenge facing all sectors that engage in international trade. Second, the success of both Japan and the newly industrialized countries in producing high-quality goods that make effective use of the new technologies has forced many Canadian firms to recognize that their competitors will soon be able, if they are not already, to replicate production of many of the goods and services that we now produce. In short, the adjustment challenge is pervasive and unending. The Council has therefore prepared a Statement on adjustment policy that is relevant to, but not limited by, the current challenge of adapting to freer trade between Canada and the United States.

To manage adjustment, it is not enough to see the competitive pressures on the horizon. We must also endeavour to understand the responses of industries, firms, and employees to the pressures of a changing environment and then assess how their responses influence policy makers. In Section 2 of this Statement, we set out a conceptual framework to help in interpreting the responses of the private and the public sectors to adjustment pressures.

Then, in Sections 3 and 4, which summarize the findings of a considerable body of new research undertaken by the Council, we add flesh to that framework in two quite distinct but complementary ways. Section 3 describes the actual adjustment that has been taking place. The effects of structural change on unemployment are of critical concern, so we devote most of our attention to examining the turnover of jobs (initiated by firms) and the mobility of workers. Since foreign-owned corporations may react to the pressures for change differently than Canadian-owned firms, we also attempt to assess whether firm-initiated responses differ, depending on the country of ownership.

In Section 4, we concentrate on "trade-sensitive industries" – those industries which have received sector-specific government assistance because of the pressures of international competition. Our analysis focuses on the use of three policy instruments: special import measures, particularly quantitative restraints on imports; capital subsidies to firms and industries; and labour market policies. We examine the way in which these instruments have been applied in the shipbuilding, automobile, footwear, textile, clothing, and pulp and paper industries.

The research findings highlighted in Sections 3 and 4 lead us to conclude that, by and large, special industry policies have had a low payoff. At the same time, the number of industries considered trade-sensitive (as indicated by the fact that they have been the beneficiaries of specific adjustment programs) has increased over time. As a result, governments have become more involved in adjustment policy. This is important, because our work suggests that if change is delayed for too long as a result of sector-specific assistance by governments, the adjustment that must eventually take place will be far more difficult to cope with for people in the affected industries than would be the case without such assistance. The Council's conclusions and recommendations on how best to manage the adjustment process are presented in Section 5.

## 2 The Tools of Adjustment

Individuals and firms respond to competitive pressures by reallocating their talents and resources within occupations, firms, industries, and regions. This reallocation takes place according to a set of laws, regulations, and customs devised by society to accommodate the process of change. Two broad types of policy underlie these laws and regulations: framework policies, which are of general application and economywide in scope; and sector-specific policies, which are targeted at individual industries. Usually the framework policies provide sufficient support to firms and workers to enable them to respond to the pressures for adjustment. In other words, when workers change jobs, retrain, or retire and when firms are born, die, expand, contract, introduce new product lines, innovate, find market niches, and export, they do so within a set of rules that govern the economy.

In some cases, however, the pressures for change and adjustment are so great that the framework policies cannot cope with them adequately. Government then steps in with policies designed to manage change in those particular sectors. In the parlance of this Statement, these are "trade-sensitive sectors." Figure 1, which illustrates the conceptual framework that we are using, shows these two types of policies.

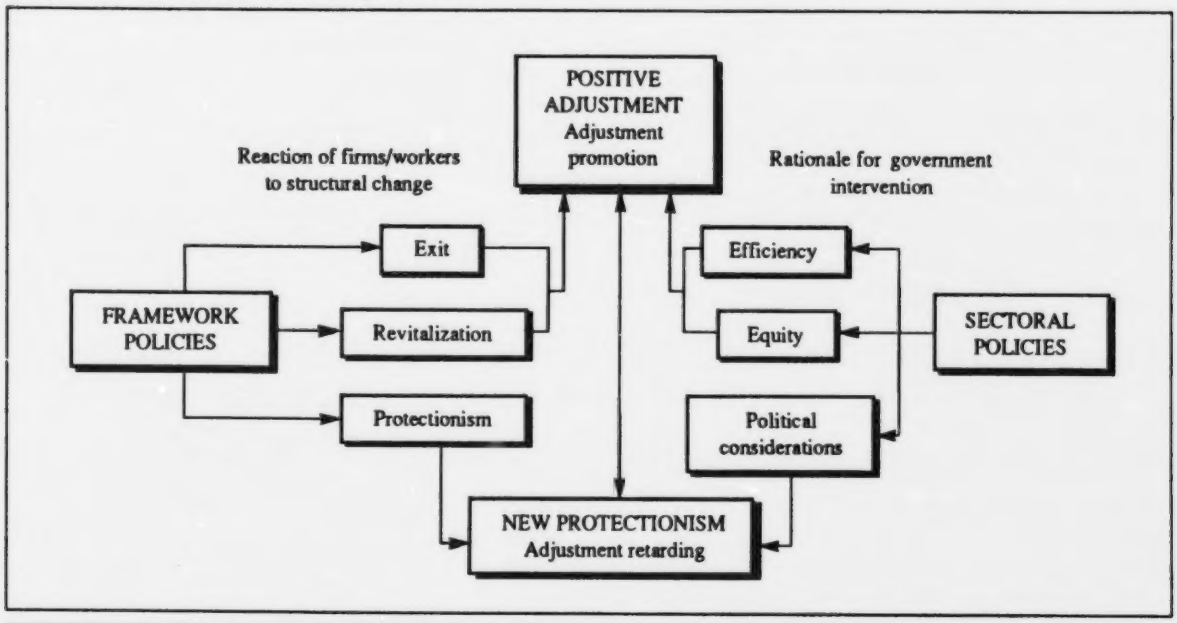
### *Framework Policies and Adjustment Options*

Framework policies can be either national or international in their setting. On the national level they include: unemployment insurance; worker training and mobility programs; rules and regulations governing management/labour relations, including collective bargaining; competition policy; laws governing business incorporation, bankruptcy, and access to credit; and, finally, macroeconomic policies aimed at the growth and level of output, employment, and prices (including interest rates and exchange rates). At the international level, one of the most important framework policies is the General Agreement on Tariffs and Trade, which came into force on 1 January 1948 and has provided the setting for successive rounds of multilateral tariff reductions, as well as a structure within which world trade rules can be drawn up.

There is general agreement that governments in Canada play a very useful and necessary role in setting the rules of the market system and hence in contributing to the country's economic development. Framework policies do more, however, than just provide a stable economic and social environment within which firms and employees facing the opportunities and challenges of competition make their decisions. In some important respects, framework policies facilitate the movement of labour and capital from slower-growing towards faster-growing industries. By providing an environment within which market processes can function efficiently and effectively, framework policies let market signals indicate where returns are the highest and where they are the lowest, and thus where resources should be directed. For example, unemployment insurance and training programs enable individuals to find and enter the growth areas more easily. In the same way, programs

**Figure 1**

**Responses to competitive trade pressures**




designed to disseminate information on new technology and marketing niches make firms aware of new opportunities. In response to the pressures for change, these policies thus nudge the economy towards a new combination of output and employment in which overall economic activity can be maximized.

We shall now examine how firms and individuals react to the pressures for change within the set of framework policies in place in Canada (as shown on the left side of Figure 1). Three adjustment options are discussed in turn: exit, revitalization, and protectionism.

*Exit*

One of the options available to firms and individuals in industries battered by international competition is to leave (or "exit") the industry. When a firm perceives a permanent decline in demand for its product lines and the consequent adverse impact on profitability, it may decide to leave the industry. There are two exit routes: the firm can sell its plant and equipment to another firm; or it can gradually run it down. In the second case, workers will be laid off and have to search for work in other industries and occupations – an endeavour in which they may or may not be successful. Where international competition is sudden and unexpected, the firm may actually go bankrupt – an obviously painful method of exit. Under favourable circumstances, the exit process can be orderly if the firm finds alternative uses for its resources in other industries; this is more likely if it already has a diversified range of product lines.

*Revitalization*

The next option is "industry revitalization" – the restoration of an industry's international competitiveness. One choice is for the firm faced with increased international competition to meet the challenge by designing better products and improving the organization of production and sales so that costs will be lower and quality higher. A second alternative is an extension of the first: the firm can lower its costs by reducing wage rates, the returns to its investors, and/or the level of compensation to management. The feasibility of this route depends upon the extent to which people are willing to stay with the firm and work for lower rewards, which in turn usually depends upon the availability of higher rewards elsewhere. A third choice is "differentiation" – finding a market niche – whereby the firm specializes in some of its existing product lines or develops new ones in which it can become more internationally competitive. The first and third choices are sometimes referred to as "rationalization."

*Protectionism*

The third and final option is for the firm, usually with the support of labour, to seek protection from import competition. Protection can take a variety of forms, including quantitative import restraints, tariffs, subsidies, and outright prohibition on the importing of certain foreign goods. The effect of all such policies is to raise the relative price of imports so that the domestic import-competing industry can avoid selecting either the exit or the revitalization option described above, depending on the duration and effectiveness of the protection granted. Groups seeking protectionist measures claim that framework policies cannot respond to their particular needs.

### *Sectoral Policies*

It is true that framework policies do not always work. When they do work, they are often perceived as working too slowly or as yielding unacceptably harsh results. So, from time to time, governments have responded to the demands of different groups in society by intervening on a more *ad hoc* basis and targeting special programs at individual groups of workers, firms, or industries that are adversely affected by the pressures of change. In addition to the protectionist measures already noted, such interventions may take the form of special labour adjustment programs or bailouts of individual firms. These sectoral policies are usually justified on grounds of efficiency or equity, but political considerations also play a major role. These three possible rationales for government intervention are shown on the right side of Figure 1.

*Rationales for Government Intervention*

Because financial markets generally appear to work well in Canada, there is little justification for assisting firms on *efficiency* grounds. Individual investors and firms can generally diversify their investment portfolios and borrow against their assets to finance new investments. They are supported both by their own information networks and by financial intermediaries in obtaining data on the riskiness of national or international projects.

Workers, in contrast, cannot diversify their risks as easily. They operate in local, not national or international, markets; they have access to much less information on job opportunities than investors or firms have to data on market and investment conditions; and they have much greater difficulty borrowing in order to retrain than does a firm in financing a new investment opportunity. In addition, training – particularly of a general nature – may not be readily available, since individual firms have little incentive to train workers. This is because they may lose the full benefits of any training they provide if other firms bid away the trained workers.

We conclude, therefore, that there are efficiency grounds for government intervention to provide information, retraining, and support to workers who want, or are forced, to find employment elsewhere in response to changes in the economy. The case is particularly strong when a major plant shuts down in a small community, with a consequent severe impact on employment opportunities. Those who are already unemployed will find it much more difficult to find jobs, through no fault of their own. Such "congestion externalities" strain the ability of local labour markets to adjust and thus warrant special assistance.

*Equity* is a difficult concept to define or to invoke unambiguously when justifying particular sectoral adjustment policies. It is usually associated with the notions of "fairness," "justice," and absence of bias, and is concerned with what people, or society, would consider to be fitting or right. In the case of adjustment, we note that while the benefits of a particular change, such as a reduction in trade barriers, tend to be widely shared, the losses tend to be borne disproportionately by a relatively small group. In Canada, the tendency for the victims of change to be concentrated in certain distressed regions and localities provides additional force to the equity rationale for government intervention. It is thus argued that government has a moral obligation to ensure that the burden of adjustment will be shared by all members of society, since ultimately all are beneficiaries.

Like the efficiency arguments, the equity arguments for adjustment assistance are most persuasive in the case of workers. There is generally less sympathy for investors who incur a loss as a consequence of change, since they are usually in a better position to contend with risk because of the opportunities provided by capital markets for risk-pooling and risk-spreading. This is not necessarily the case for small firms, however; there may be instances in which equity would argue in favour of intervention to prevent small firms from having to shoulder a disproportionate share of the adjustment burden.

Finally, governments sometimes intervene primarily for *political* reasons, in response to the demands made by the firms, employees, and regions. Clearly, elected representatives must pay attention to such demands. Hence, because of this political rationale for intervention, government may grant a degree of protection to workers and firms, even though the efficiency or equity rationale may be lacking. Frequently, such protection is of considerable duration, thus postponing the day when the firm will be forced to adjust.

A government decision to intervene in a particular sector in response to the pressures of international competition is often the result of a careful balancing of the efficiency, equity, and political rationales. The final outcome will not only depend, however, on the intrinsic merit of each rationale and on the vigour with which it is defended in Cabinet, but it will also be conditioned by a number of other factors. These include the general state of the economy, the government's fiscal position, the prevailing social attitudes towards change, the economic ethos of the party in power, the visibility and transparency of the method of intervention selected, the precedent that the awarding of special assistance may set for other sectors, and the reactions of foreign governments and organizations.

It is clearly difficult for any government to start from scratch and design an optimal adjustment strategy. Yet, under ordinary circumstances governments do have some measure of discretion in deciding whether to award sectoral assistance and on what terms. In our review of the adjustment process and of adjustment policies, we shall attempt to provide guidelines for the use of this discretion.

*Policy Instruments*

Once government has decided to intervene at the sectoral level, it must choose the instruments with which the policy is to be implemented. From the point of view of their effects, the instruments available range between "positive adjustment" (at the top of Figure 1) and the "new protectionism" (at the bottom of the figure). Positive adjustment attempts to accommodate, facilitate, and promote adjustment along the path indicated by competitive pressures, while new protectionism arrests, thwarts, or retards the pressures from international competition.

The efficiency and equity rationales for intervention would suggest that special labour-market adjustment policies be adopted to encourage re-employment and perhaps provide income compensation to selected groups. If quantitative import restraints are to be used because of a sudden surge in imports, efficiency and equity considerations suggest that they be imposed for a limited time only. These two adjustment-promotion measures are designed to complement the framework policies, which, by and large, are intended to perform much the same functions at the economywide level. Taken together, labour adjustment policies and quantitative import restraints may be viewed as being at the "positive adjustment" end of the policy spectrum.

In contrast, intervention based on political considerations is much more likely to retard adjustment. Workers and firms are not encouraged to leave industries when the forces of change would suggest that they should do so. In these cases, less rather than more visible instruments of intervention are employed; quantitative import restraints are imposed for longer, not shorter, periods; capital subsidies are used to revitalize industries that, frequently, have little chance of becoming internationally competitive; and little emphasis is placed on labour re-employment. This group of policies is at the "new protectionism" end of the policy spectrum shown in Figure 1.

In summary, sectoral intervention will lead to quite different outcomes, depending on the rationale accepted, the policy objective chosen, and the instrument used. The efficiency and equity arguments will tend to promote adjustment, while political motivations will tend to retard it. Thus when governments decide to intervene on a sectoral basis, there is likely to be tension between the efficiency and equity rationales, on the one hand, and the political rationale, on the other.

## 3 The Adjustment Experience

In this section, we analyse the adjustment of Canadian firms and workers to the pressures of international competition, concentrating on the manufacturing sector. We focus on manufacturing because it is the dominant sector in Canada's trade with other countries and the importance of manufactured imports and exports has increased over the past four decades (Table 1). In addition, the pressures for adjustment in this sector are sufficiently different – in terms of its economic structure, its exposure to foreign competition, and its treatment under GATT – from those experienced in other sectors (such as services and agriculture) to warrant separate attention.

Manufacturing makes an important contribution to the Canadian economy. It has accounted for approximately one-fifth of the country's output of goods and services in the postwar period, although its relative importance in terms of employment and capital stock has declined (Chart 1). These divergent trends reflect the increase in productivity that has occurred in manufacturing, enabling resources to be released to other sectors of the economy. Nevertheless, in terms of either the number of workers or the volume of total output (particularly the latter), the Canadian manufacturing sector has increased in absolute size since 1971 (Chart 2). Similar patterns have been observed in a number of other industrialized countries.

Charts 3 and 4 depict the trade environment in which the manufacturing sector operates. The continued

**Table 1**

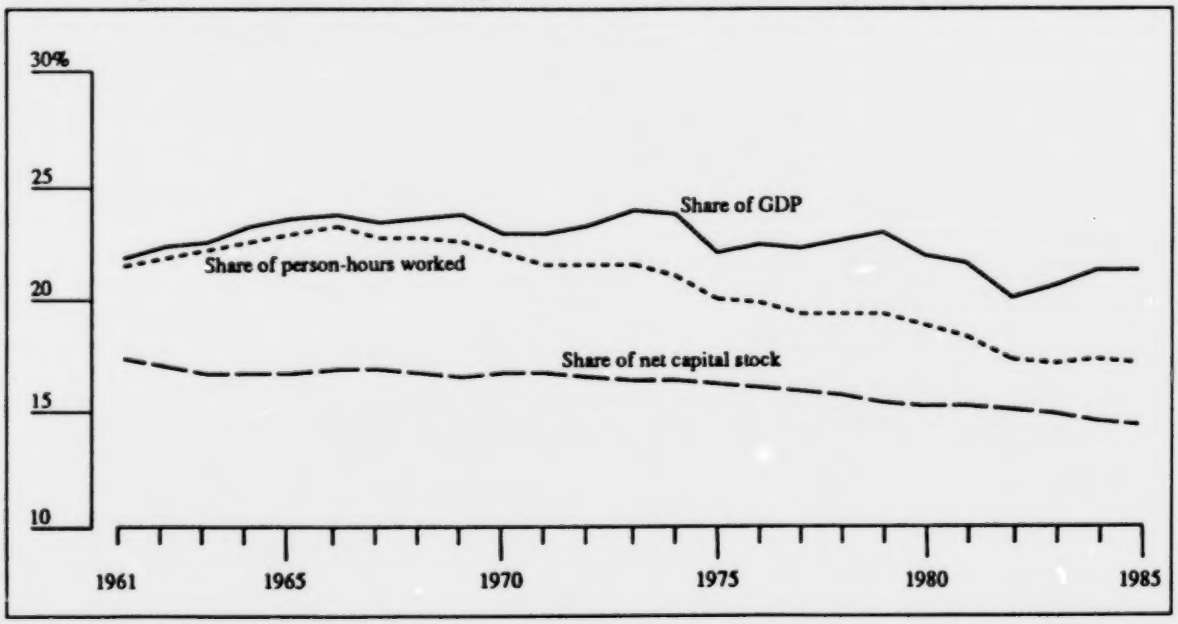
**The importance of manufactured imports and exports in the structure of Canada's trade, 1950-85[1]**

| | Manufactured goods as a proportion of: | | | |
|---|---|---|---|---|
| | All goods and services | | All goods only | |
| | Imports | Exports | Imports | Exports |
| | (Per cent) | | | |
| 1950 | 45.1 | 54.9 | 65.7 | 72.6 |
| 1955 | 53.1 | 54.3 | 76.1 | 72.1 |
| 1960 | 50.5 | 51.8 | 77.5 | 67.3 |
| 1965 | 53.7 | 51.9 | 81.0 | 66.3 |
| 1970 | 57.2 | 59.2 | 85.2 | 74.5 |
| 1975 | 58.9 | 55.0 | 79.4 | 66.6 |
| 1980 | 56.1 | 61.2 | 78.3 | 73.2 |
| 1985 | 62.0 | 65.0 | 88.2 | 77.4 |

1 Based on current-dollar values of imports and exports.
SOURCE Economic Council of Canada, CANDIDE database, based on data from Statistics Canada.

**Chart 1**

**Relative importance of the manufacturing sector in the Canadian economy, 1961-85**



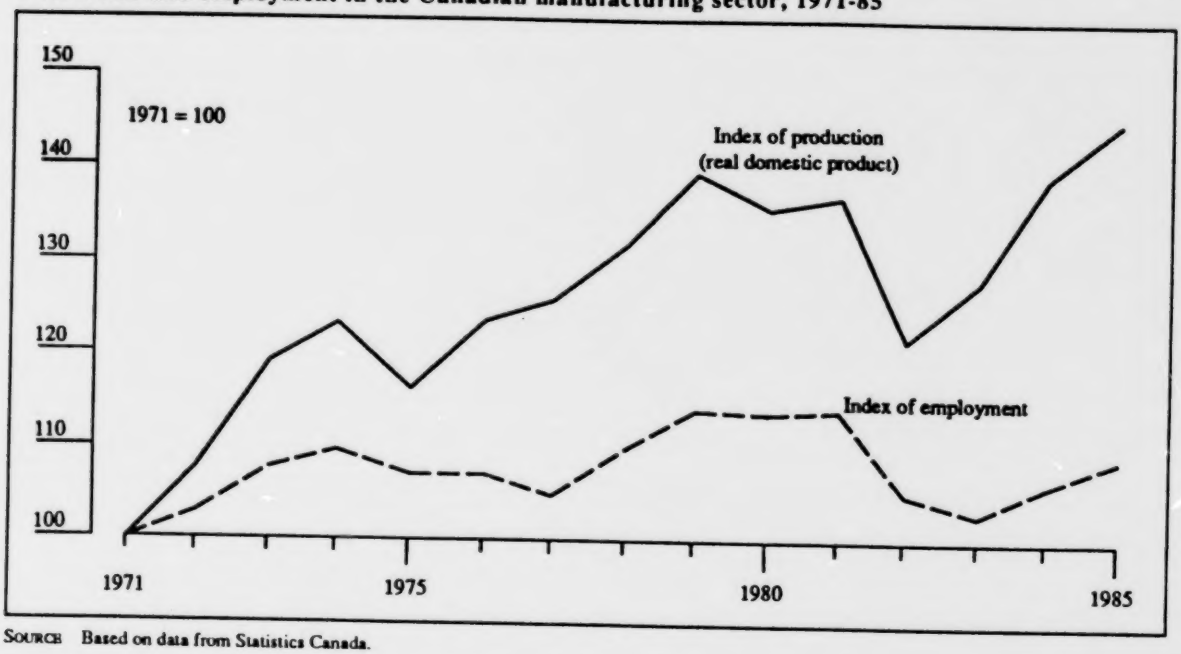

SOURCE Based on data from Statistics Canada.

liberalization of trade, measured in terms of falling tariffs (Chart 3), and the growing importance of both imports and exports (Chart 4) create opportunities for Canadian firms to sell on world markets as well as increasing import pressure on domestic suppliers.

It is against this background that we examine two vitally important aspects of the adjustment that is taking place within Canada's manufacturing sector: labour market turnover, whether initiated by firms or by workers; and the impact of foreign ownership. In both instances, we present

**Chart 2**

**Production and employment in the Canadian manufacturing sector, 1971-85**




SOURCE Based on data from Statistics Canada.

the results of new research undertaken at the Council and elsewhere.

### *Adjustment and Labour Force Turnover*

The fate of workers is a major concern in any consideration of the need for adjustment in trade-sensitive industries. Indeed, as suggested in Section 2, the rationale for government intervention in the adjustment process is much stronger with respect to labour than with respect to capital. While public attention is often focused on the predicament of those workers who are laid off when a firm closes a plant or reduces the scale of its operations, the hiring of workers when a new plant opens or an existing one expands is seldom accorded the same treatment. Yet, as Chart 2 shows, employment in the manufacturing sector has increased over time. In view of the pressures for change being exerted on Canadian industry, it is important to understand, and to measure, the extent to which labour market turnover and mobility are a normal part of the workings of the economy, both in the manufacturing sector as a whole and in selected trade-sensitive industries.

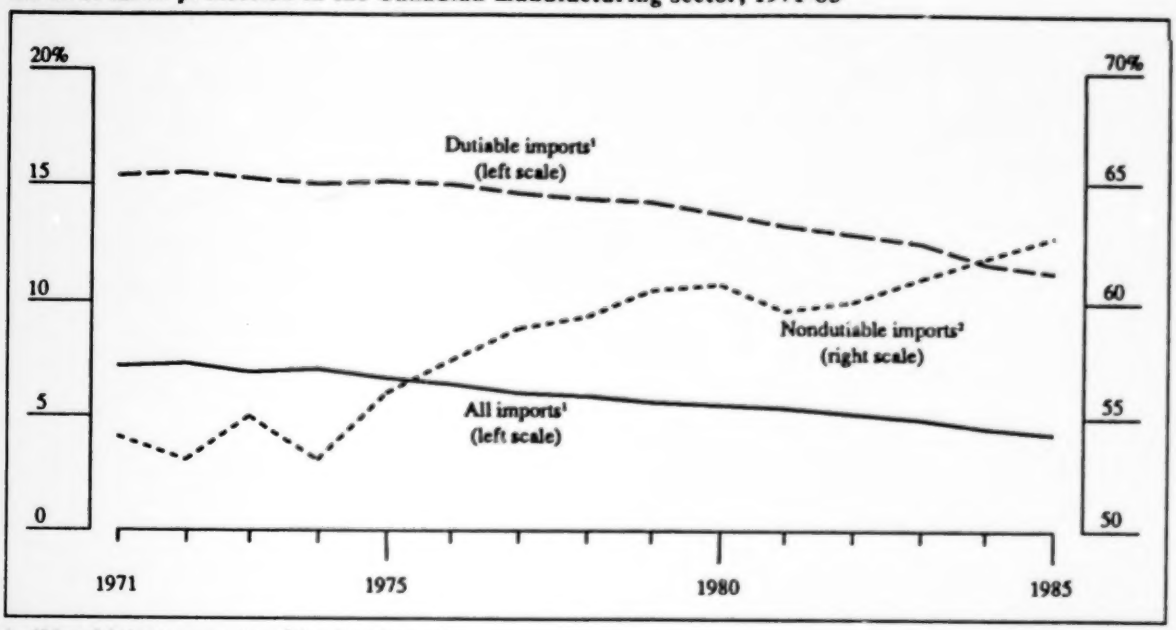
### *Labour Market Turnover*

Two complementary approaches have been used to provide a comprehensive understanding of the effects of structural and cyclical changes on labour market turnover. The first focuses on *job* turnover – that is, on the creation and destruction of jobs in manufacturing firms and establishments. The second examines *worker* (or labour) turnover, or the flows of workers into and out of jobs. This distinction between the turnover patterns of jobs and those of job holders is important because it gives us a clear view of the respective responses of labour demand and of labour supply to changes in market conditions.

In this context, job turnover is viewed as being firm-initiated, in the sense that it reflects the changes in employment that result from the creation, expansion, contraction, or closing down of firms. Some indirect indication of the magnitude of job turnover is provided in Charts 5 and 6, which show that large numbers of firms began or ceased operations during the decade 1970-79. For example, over 40 per cent of the firms operating in the average manufacturing industry in 1970 had left the industry by 1979, mainly through plant closure (Chart 6).

**Chart 3**

**Level of tariff protection in the Canadian manufacturing sector, 1971-85**




1 Value of duties as a proportion of the value of imports.
2 Proportion of all imports that is not subject to duties.
SOURCE Based on data from Statistics Canada.

Worker turnover, on the other hand, occurs when workers join a firm or leave it, or when they move between firms for various reasons – layoffs, quits, pregnancy, return to school, and so on. Obviously, the figures for job and worker turnover overlap to a certain extent, particularly the figures on job disappearance on the firm side and on permanent layoffs on the worker side. But they are unlikely to match perfectly. For example, large numbers of workers may join and then leave a firm or establishment over a given period, while the actual number of jobs in the organization remains unchanged. In that case, there will be significant worker turnover but no job turnover. Both types of job change must be examined, because judgments based on job turnover alone will underestimate the total amount of labour market turnover.

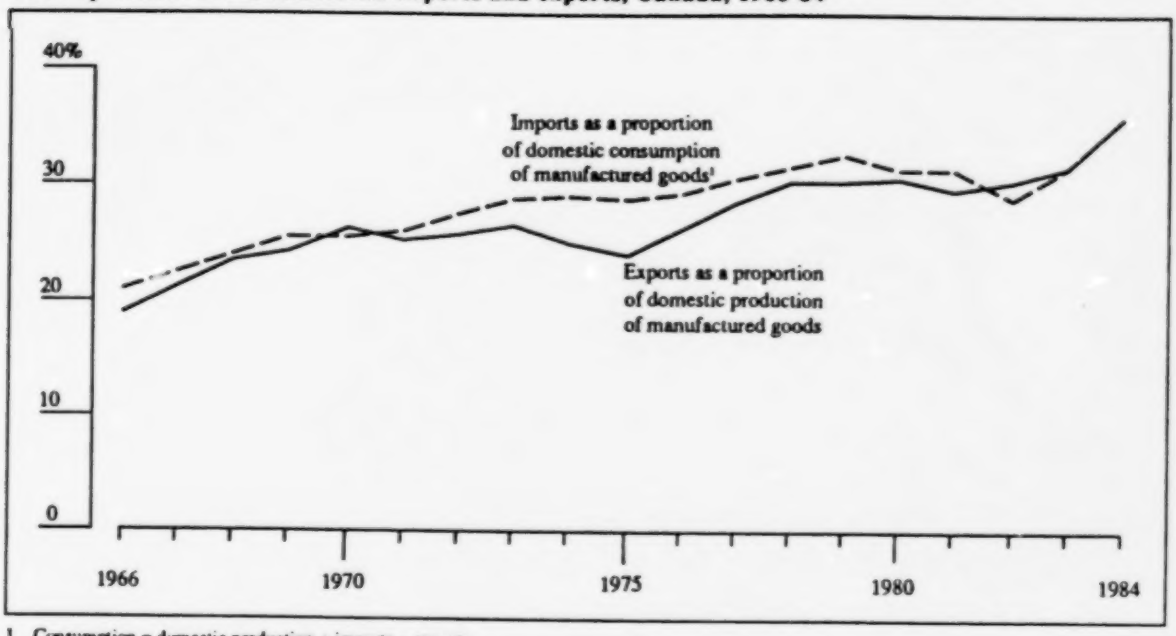
There are economic benefits and costs associated with turnover in the labour market. Among the benefits are the efficiency gains that stem from the replacement of unsuccessful firms with more successful ones and from the movement of firms away from declining industries into growing ones. Benefits also result from workers sorting themselves out in such a way that they find jobs that better match their skills. For workers, the financial costs of turnover caused by actual or anticipated layoffs include the income lost during the job search, the out-of-pocket expenses involved, and the cost of moving to a new location. For the owners of capital, the costs of a firm's decline or closing involve losses in the value of their holdings.

*Job Turnover* — A considerable amount of adjustment to change is continually taking place in manufacturing. Labour is constantly being reallocated, as the fortunes of firms rise or fall within both growing and declining industries. Note, however, that the extent to which workers actually change employers when their jobs disappear depends on whether the decline in the firm's activity is permanent or temporary and, in the latter case, on whether the workers seek employment elsewhere or withdraw from the labour force.

Before drawing any conclusions, we must be sure that we are using the right measures. Job turnover may be measured by focusing on changes in employment at either the firm or the establishment (or plant) level. The two approaches yield different results. For example, while the merger of two firms will result in a single, larger company, it does not necessarily involve the creation or destruction of jobs but

**Chart 4**

**The importance of manufactured imports and exports, Canada, 1966-84**




1 Consumption = domestic production + imports – exports.

SOURCE Canada, Department of Regional and Industrial Expansion, *Manufacturing: Trade and Measures, 1966-84* (Ottawa: DRIE, 1985).

merely a change in the ownership of the units of production. In this instance, using aggregate figures would lead us to conclude that a given number of jobs had disappeared in the absorbed firm and that an identical number had been created in the "new" firm, thus overestimating both the loss and the creation of jobs. Because of this potential overestimation of the real job turnover, we use establishment-based data, which reflect more accurately the amount of employment change that actually takes place.

The time period considered may also affect the measurement of job turnover. For example, an establishment may create jobs in one year and terminate them the following year but yet show little net job turnover over a longer period. These short-run changes in employment are mainly the result of cyclical fluctuations that tend to offset one another from year to year. That explains why short-term estimates of job turnover tend to be higher than longer-run estimates, which better reflect the structural change within an industry. Longer-run figures may not, however, capture the actual amount of labour market turnover that stems from changes in producers' fortunes. Short-run fluctuations in output and employment will better measure this phenomenon if the associated annual layoffs move to other employers during temporary year-to-year output changes. We have therefore calculated the components of job change both on a yearly basis and for longer periods.

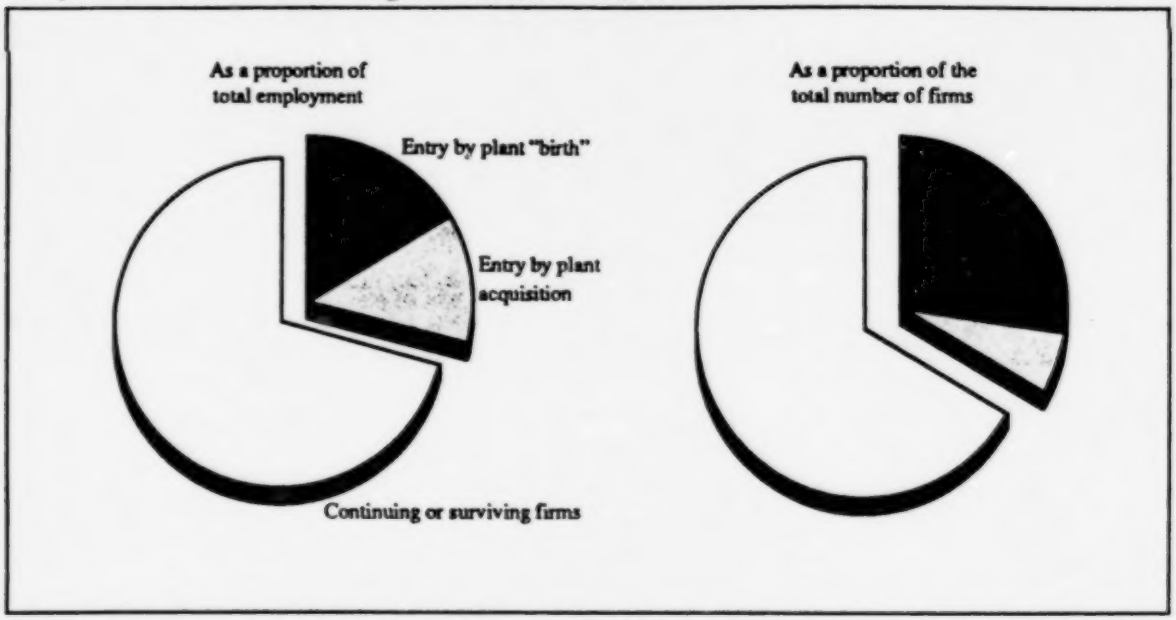
Each year, a large and relatively constant proportion of jobs in manufacturing disappear as a result of the decline or closing of manufacturing establishments – over 8 per cent, on average, during the 1970s (Chart 7). When calculated over a five-year period – to eliminate the effect of short-run fluctuations – the average job-loss rate per year exceeds 4 per cent; over a 10-year period it is 3.6 per cent. The latter figure reflects the fact that at least 30 per cent of the jobs that existed in 1971 had disappeared a decade later.

*Worker Turnover* — Worker turnover is measured by looking directly at the number of workers who leave their employers. These separations are either temporary (when the workers return to the same employer within two years) or permanent. "Worker separations" can be divided into two different but related components – displacement and attrition.

Displacement refers to firm-initiated layoffs. An analysis of administrative data supplied by the Department of

**Chart 5**

**Entry of firms into manufacturing industries, Canada, 1970-79[1]**


As a proportion of total employment
Entry by plant "birth"
Entry by plant acquisition
Continuing or surviving firms
As a proportion of the total number of firms

1 The shares are based on average percentages for 141 Canadian manufacturing industries. The percentages were derived by comparing the status of firms in 1970 and 1979; firms that existed in 1979 but not in 1970 are viewed as entrants, whereas firms that were present in both years are viewed as continuing firms. All percentages are based on 1979 figures for firms or employment.

SOURCE J. R. Baldwin and P. K. Gorecki, with J. McVey and J. Crysdale, "Entry and exit to the Canadian manufacturing sector: 1970-1979," Economic Council of Canada, Discussion Paper No. 225, Ottawa, 1983; and J. R. Baldwin and P. K. Gorecki, "Structural change and the adjustment process," a background paper prepared for the Economic Council of Canada, 1987.

Employment and Immigration shows that the number of permanent layoffs in any given year is at least as large as the 8 per cent of jobs that disappear each year. This means that the annual establishment-based job-loss rates that we have observed reflect firm behaviour that results in workers being laid off permanently rather than short-term reductions in employment after which workers return to the same employers.

Attrition, on the other hand, is worker-initiated, although it may sometimes be caused indirectly by the decline of a firm, which leads workers to anticipate a layoff and thus leave their jobs. It is divided into several categories for administrative purposes: labour dispute; return to school; illness/injury; quits; pregnancy; early retirement; and other. The same administrative data show that on an annual basis over the period 1974-82, "quits" was the primary cause of attrition.

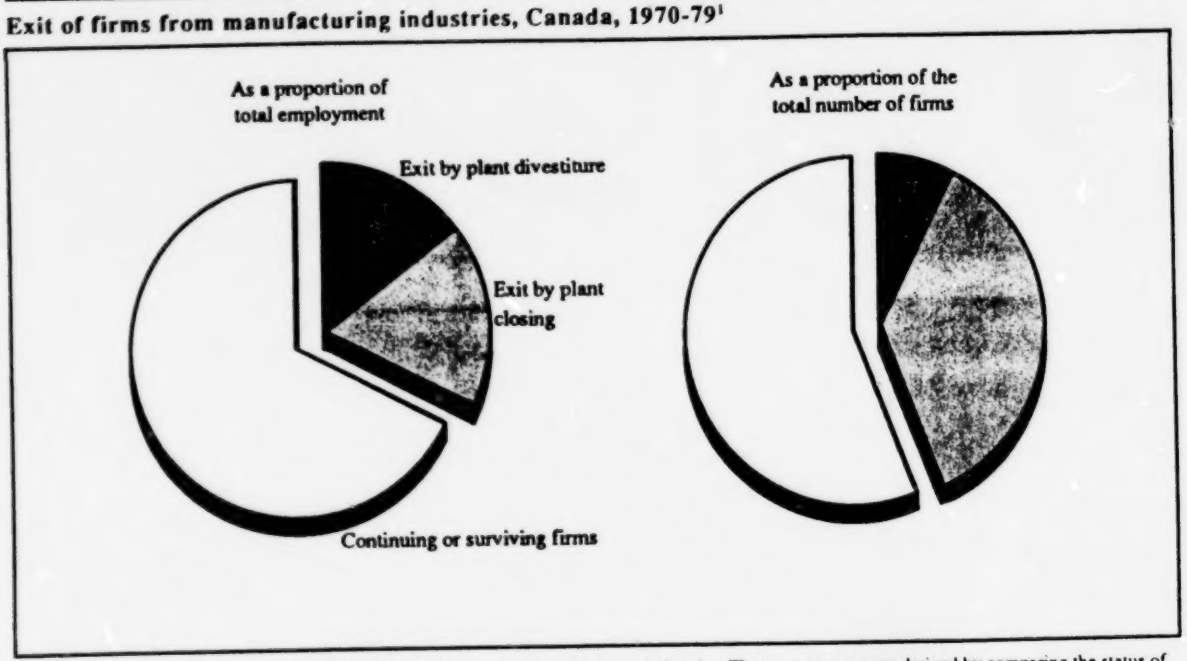
Attrition is a component of worker turnover that is not captured by our establishment-based job-turnover measures nor by displacement estimates. While an establishment may reduce its work force by eliminating jobs, workers may also leave their employers voluntarily. In doing so, they contribute to the adjustment process. It is therefore important to measure the magnitude of attrition in order to have a more comprehensive view of the volume of labour market reallocation that the economy manages to absorb each year.

The results show that when measured on an annual basis, worker-initiated attrition is approximately as important as all firm-initiated layoffs, whether permanent or temporary. When the temporary component is removed from both sets of figures, we find that permanent layoffs and permanent attritions together amount to more than 20 per cent of employment annually in the manufacturing sector.

The conclusion here is inescapable: a very large number of people change jobs and employers in the manufacturing sector each year, either for personal reasons or because of changing economic conditions.

**Chart 6**

**Exit of firms from manufacturing industries, Canada, 1970-79[1]**


As a proportion of total employment
As a proportion of the total number of firms
Exit by plant divestiture
Exit by plant closing
Continuing or surviving firms

1 The shares are based on average percentages for 141 Canadian manufacturing industries. The percentages were derived by comparing the status of firms in 1970 and 1979; firms that existed in 1970 but not in 1979 are viewed as exits, whereas firms that were present in both years are viewed as continuing firms. All percentages are based on 1979 figures for firms or employment.

SOURCE Baldwin and Gorecki, "Entry and exit," and "Structural change."

*Labour Force Mobility*

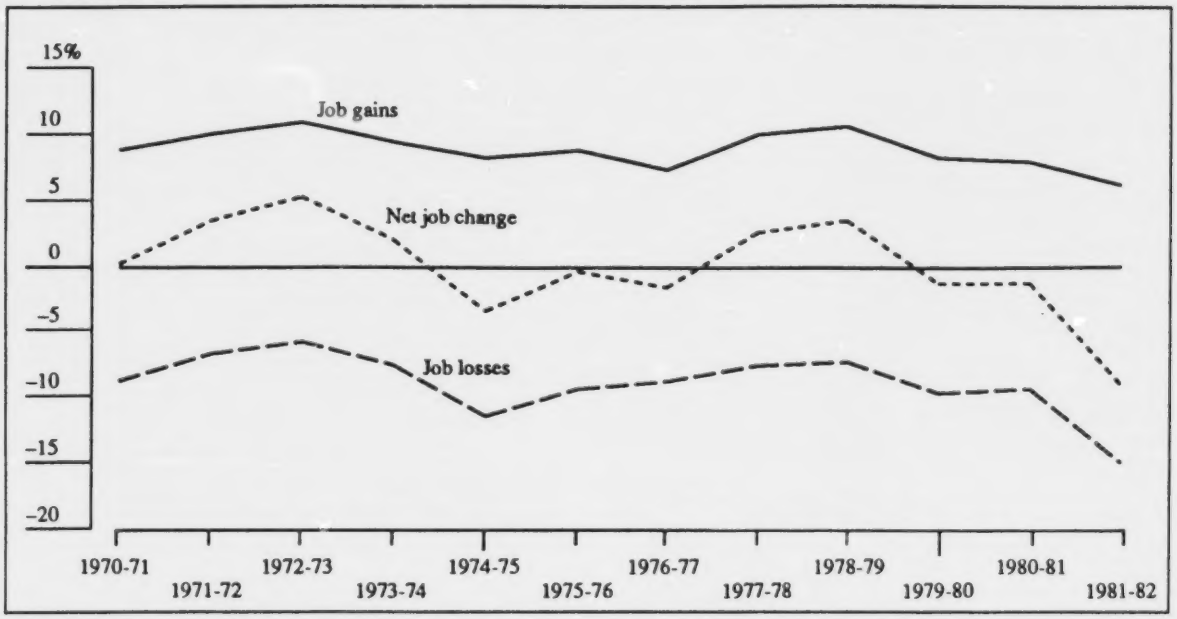
To appreciate fully the degree of adaptability displayed by Canadian workers, we have to supplement the aggregate data on labour market turnover with information on worker mobility. A large turnover of workers does not necessarily prove that they adapt easily. If workers who leave one employer move to another one in the same industry who is offering work in a closely related occupation, it may be difficult for them to adjust should that industry undergo a long-term decline in activity resulting from structural change in the economy. On the other hand, if workers move to other industries, occupations, or regions relatively frequently, we can expect adjustment to be less painful. The degree of mobility thus provides indirect evidence of the adaptability of the labour force.

We reviewed a considerable body of evidence (drawn from a variety of sources) on the mobility of the Canadian labour force. Studies of the shipbuilding, steel, footwear, clothing, textile, automobile (and auto parts), and electrical/electronics industries examined the movement of workers into and out of each industry, in terms of their sector of origin and their destination. These and other studies also addressed the issue of regional mobility. The degree of worker mobility across occupations and employers was investigated by tracking individual workers over time. Finally, the experiences of workers who moved were examined according to different age categories, using various indicators such as changes in rates of pay, the time needed to find another job, the duration of any subsequent job, and so on.

Our review of the evidence on labour mobility (which is reported in some detail in our research report and includes administrative data, special sectoral surveys, and a supplement to Statistics Canada's Labour Force Survey) leads us to believe that workers show considerable mobility between employers, industries, and occupations when they leave one job for another. That is not to deny, however, that adjustment problems are likely to be more acute in cases where the industrial base is narrow or where older workers are particularly affected.

**Chart 7**

**Annual employment gains and losses[1] in the Canadian manufacturing sector, 1970-71 to 1981-82**




1 As a proportion of total manufacturing employment.
SOURCE Baldwin and Gorecki, "Structural change."

*Turnover in Trade-Sensitive Industries*

Aggregate data for the manufacturing sector show that the number of workers constantly being released and redeployed is high. These figures could, however, hide aberrations in certain sectors. Some sectors are likely to be more affected than others by trade liberalization or by the removal of special protection or other forms of government assistance. Can we expect the adjustment process to be more difficult for their workers?

Naturally, the problem of adjusting to international trade pressures is most acute for industries facing strong competition from imports. We need to know whether import competition has forced a disproportionately high number of firms in those industries to close their doors and whether worker turnover rates are particularly low, suggesting that these industries have a narrower "natural" margin available for adaptation.

To answer these two questions, we first divided manufacturing industries into those with a high and those with a low import-penetration ratio, defined as the ratio of imports to domestic market sales. In import-intensive industries, plant closures by exiting firms accounted, on average over the 1970-79 period, for 28.4 per cent of the plants that were in existence in 1970; the corresponding percentage in the non-import-intensive industries was 29.3 per cent. Indicators of job and worker turnover also reveal little difference in turnover between the two groups of industries. Hence, on the basis of that evidence, there is little to distinguish between the two groups with respect to turnover rates.

As a second step, we examined four industries that are widely regarded as being among the most trade-sensitive: leather, textiles, knitting mills, and clothing. Indicators of labour adaptability, as measured by job and worker turnover, were developed for these industries and then compared with those for all manufacturing. The results, some of which are presented in Table 2, show that the adaptability of workers in these trade-sensitive industries was remarkably similar to the average for all manufacturing. Only the leather industry showed lower rates of layoff and attrition. Hence, despite a wide array of factors that impact on individual industries – changes in technology, in tastes, in the level of demand, in the degree of special protection, and so on – there is considerable similarity in the degree of adaptability.

**Table 2**

**Worker turnover rates[1] in the Canadian manufacturing sector, 1978**

| | Permanent layoffs[2] | Quits | Other attritions | Total |
|---|---|---|---|---|
| | | (Per cent) | | |
| Trade-sensitive industries: | | | | |
| Leather | 3.9 | 7.8 | 7.0 | 18.7 |
| Textiles | 5.9 | 8.2 | 9.2 | 23.3 |
| Knitting mills | 5.6 | 11.6 | 10.8 | 28.0 |
| Clothing | 5.8 | 8.9 | 11.1 | 25.8 |
| All manufacturing industries | 6.6 | 8.0 | 10.5 | 25.1 |

1 A percentage of employment.
2 Layoffs where workers do not return to the same employer within two years.
SOURCE M. Robertson, "Perspectives on labour adjustment in the Canadian economy," Employment and Immigration Canada, Ottawa, February 1987.

*The Impact of Trade Liberalization*

It is sometimes argued that severe job loss and dislocation will result from trade liberalization. The Council is currently assessing the impact of the proposed Canada-U.S. Free-Trade Agreement and plans to do further work on multilateral trade negotiations. Preliminary work by the Council, published in September 1987 in our Twenty-Fourth Annual Review, examined the potential employment effect of immediate implementation of a comprehensive bilateral trade agreement. (The actual agreement announced in October and signed by the heads of government of the two countries in early January is more limited in scope and will be phased in over 10 years.) The September analysis indicated that total employment changes (both gains and losses) would not be large in the context of the high degree of job and labour turnover that we have shown to exist in the manufacturing sector. This conclusion holds whether turnover is measured in the long or the short run.

It is useful, however, to have an additional benchmark against which to measure the consequences of particular changes. One such benchmark is the long-term loss of jobs attributable to the decline or closing of establishments. Since the number of jobs lost is a measure of the net long-term effects of different forces on individual production units, it gives us a picture of the effects of changes in Canada's industrial structure.

Our research shows that there is a relatively large and constant proportion of manufacturing firms that will close their doors in any given year. This self-selection process continues at approximately the same rate, whatever the pace of structural change – except when times get tough. For the manufacturing sector as a whole, this process resulted in some 18 per cent of the jobs that existed in 1970 having disappeared by 1979.

The long-term rate of firm closings can be considered as a normal (or benchmark) rate of exit associated with a certain percentage of job loss. If trade or quota liberalization led to a much higher rate of firm exits, this would signal the need to slow down tariff reductions or quota removals; on the other hand, if the rate of exits was significantly slower than the benchmark rate, tariff reductions could be speeded up.

Our research also shows, however, that in the long run, industries in which sales are declining adjust to lower levels of output; about half of that adjustment occurs in the form of reduced entry rates, and about half through increased exit rates, compared with growing industries (Table 3). In addition, industries grow not so much through lower exit rates as through higher entry rates.

Part of the adaptation thus takes place as workers who would normally lose their jobs as a result of the dynamics of firm decline move to firms that are starting up. As we have

**Table 3**

**The impact of firm entry and exit rates on industry employment change: An illustrative example[1]**

| | Year | | |
|---|---|---|---|
| | 1 | 5 | 10 |
| In a growing industry: | | | |
| Employment at start of year | 8,000 | 8,064 | 8,144 |
| Effect of firm exit (1.6 per cent decrease in employment) | –128 | –129 | –130 |
| Effect of firm entry (1.8 per cent increase in employment) | 144 | 145 | 147 |
| Net employment change over the year | 16 | 16 | 17 |
| In a declining industry: | | | |
| Employment at start of year | 8,000 | 7,531 | 6,983 |
| Effect of firm exit (2.5 per cent decrease in employment) | –200 | –188 | –175 |
| Effect of firm entry (1.0 per cent increase in employment) | 80 | 75 | 70 |
| Net employment change over the year | –120 | –113 | –105 |

1 Based on the record of Canada's manufacturing industries in the 1970s. A declining industry is defined as one in which sales decrease, while a growing industry is one where sales increase. Firm exit refers to plant closure; firm entry, to plant creation. While actual exit and entry employment percentages have been used, the figure of 8,000 for employment is illustrative only.

SOURCE Based on Baldwin and Gorecki, "Entry and exit," and "Structural change."

shown, workers are not confined in their search for jobs to a narrow range of employers in the same industry: they transfer to other industries and occupations in a way that suggests substantial mobility. Sensible public policy in the area of adjustment assistance should therefore facilitate, not hinder, this natural movement of workers who are continually transferring from declining to growing industries.

The data on which we base our conclusions concerning labour and job turnover do not take full account of the recession of 1982, the worst in Canada's postwar economic history. Much of the work that we have conducted is predicated upon a normal rate of firm exit and consequent job loss. When times get tough, we see a substantial rise in the exit rate and in the resulting loss of jobs (Chart 7). This may reduce mobility and certainly causes considerable hardship and pain to workers who are laid off. However, there has been a recovery from the 1982 recession, both in manufacturing (Chart 2) and in the economy as a whole. Furthermore, the evidence available suggests that the patterns and level of job change have now returned to the pre-1982 levels.

We consider, therefore, that our findings on turnover in the labour market and the conclusions that we draw from it are relevant for policy making in the latter part of the 1980s and in the 1990s. Our confidence reflects the fact that the labour-market adjustment patterns that we have observed can, to a large extent, be found elsewhere – in the non-manufacturing sectors of the Canadian economy and in other countries, including the United States, the United Kingdom, West Germany, Sweden, and Japan. This is a persuasive result, given the differences between these countries with respect to institutional settings, the pressures for change and the capacity to deal with them, unemployment levels, time periods, and the importance of different sectors in their economies.

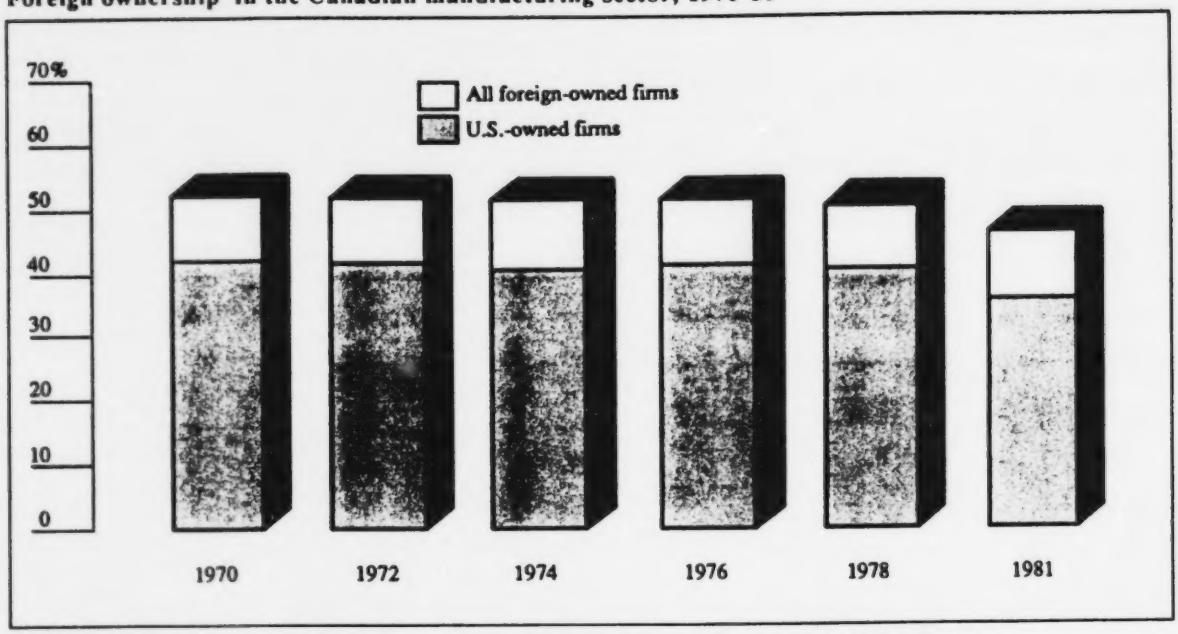
### *Adjustment and the Multinational Enterprise*

Foreign-owned firms operating in Canada may respond to the pressures for change differently than would Canadian-owned firms, with different implications for the speed of adjustment, the choice of an adjustment option, and the quality of employment – an issue that we have not yet touched upon. These are important issues for Canadians, given the significance of foreign ownership in the manufacturing sector in Canada as a whole (Chart 8) and in the different regions of the country (Chart 9). In order to address these issues, we commissioned an in-depth analysis of the adjustment undertaken by multinational enterprises in Canada. A full account of the results will be found in our research report and in a research study soon to be published by the Council.

One of the principal reasons that foreign-owned firms may respond differently to the forces of change is that they have access to a worldwide range of investments when deciding where to expand or contract their operations. This

**Chart 8**

**Foreign ownership[1] in the Canadian manufacturing sector, 1970-81**




1 Measured by the shipments of foreign-owned firms as a proportion of the shipments of all manufacturing firms in Canada.
SOURCE Based on data from Statistics Canada.

has given rise to a number of concerns: that the multinational enterprise (MNE) may be more inclined to shift production to countries with lower-cost inputs (including lower wages); that MNEs are more prone to close down their plants in this country than are Canadian-owned firms; that Canadian affiliates are not sufficiently involved in the high-growth R&D industries where MNEs are frequently important; and that as tariff barriers fall, MNEs with plants in Canada will relocate in the United States rather than rationalize their Canadian operations.

*The Choice Facing the Multinational Enterprise*

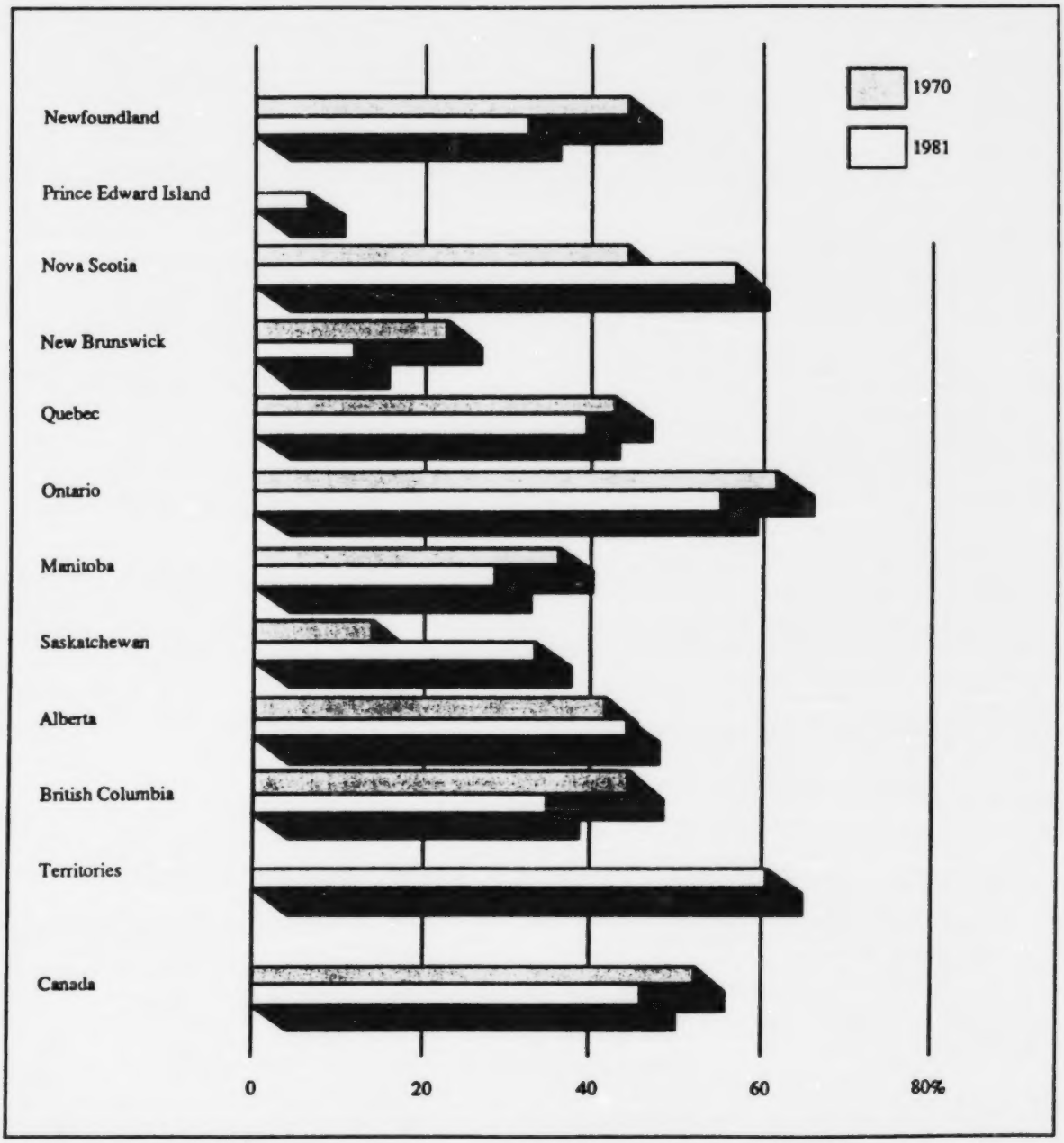
In terms of adjustment, it is often suggested that the Canadian affiliates of multinational enterprises will respond to changes in technology, international competition, or trade policy in ways that are less favourable to the domestic economy than are the responses of Canadian-owned firms. This concern is, in part, a restatement of the belief that host economies seldom benefit from foreign investment. It is reinforced by the fear that, with increased pressure from international competition and trade policy liberalization, the days of the so-called "foreign branch plant" are numbered and that Canada may experience a mass exodus of "tariff factories" – foreign-owned plants set up under the shelter of tariff protection.

The proponents of this view acknowledge that some forms of production may not be economically feasible in Canada in the absence of barriers to trade. They fear, however, that even where production is viable, multinationals will shift production to developing countries or centralize it in their home country rather than make the required investments in Canada.

The question we have posed in our research is whether multinationals are more inclined than domestic firms to shift production abroad or to cease operations when faced with adjustment problems. It is not an easy question to answer, because multinational corporations are not strictly comparable to domestic firms. The two groups face different adjustment requirements and constraints; indeed, they may operate in different segments of the market. Thus it is somewhat idle to suggest that domestic adjustment problems would be lessened if Canadian ownership were substituted for foreign ownership. In many (and perhaps all) cases, the underlying characteristics of the market –

**Chart 9**

**Employment in foreign-owned firms[1] in the Canadian manufacturing sector, by province or territory,[2] 1970 and 1981**




1 As a proportion of total employment in manufacturing.
2 Data are not available for Prince Edward Island and the Territories in 1970, for reasons of confidentiality.
SOURCE Based on data from Statistics Canada.

technology, transportation costs, labour costs, and quality of labour – dictate both the nature of the adjustment problem and the ownership characteristics.

A multinational enterprise's decision to operate in a local economy depends on two underlying factors: the economic viability of local production; and the viability of multinational ownership of local production.

The economic viability of local production depends on domestic input prices (for labour, raw materials, energy, and capital) and on market size, transportation costs, and domestic and foreign trade barriers. An increase in the relative cost of domestic production is likely to result in the substitution of foreign for domestic supplies over the longer term. Both foreign- and Canadian-owned firms have an incentive to make this substitution.

With respect to the viability of multinational ownership of local production, it should be noted that the competitive advantage of multinational operation arises from the MNE being able to appropriate the benefits of the international transfer of intangible, "firm-specific" assets, which include technology, experience, and reputation. The technology may be protected from imitation by a patent or by secrecy; experience, by the unique organizational and business culture of the enterprise; and reputation, by a trademark. If these assets become less important in the production process or if their transfer by arm's-length means (e.g., by licensing agreements) becomes feasible, the benefits of multinational ownership are reduced. The exit of a multinational under these circumstances does not reflect a lack of loyalty to, or interest in, the local economy but merely a focus by the multinational on its basic economic function. Nor does the exit imply that domestic production is no longer feasible; it only implies that a local owner finds it more profitable than does the multinational.

*Research Results*

In order to discover if ownership makes a difference in the way in which firms react to the pressures for change, we examined several types of pressures (including tariff reductions and differences in national cost levels) and two responses – exit and revitalization. We then examined the evidence regarding the relative inclination of multinationals to shift production from country to country, to rationalize, or to exit in the face of import competition. We looked at U.S. and Australian, as well as Canadian, experience and considered, among other indicators, the share and determinants of U.S. multinational activity in Canada in relation to U.S. multinational activity worldwide, in North America, and in industrialized countries. Most of the analysis was done on an industry-by-industry basis, which enabled us to take account of the variation in growth rates of different sectors. In other words, we were able to differentiate the expanding industries, where Canada wants a growing share in the activity of multinationals, from the contracting industries, where activity is less attractive. Our conclusions follow.

First, contrary to popular perception, multinationals do not appear to be more inclined to shift their operations to low-cost foreign sources of inputs; they may even be less footloose than other firms. Indeed, with respect to the response of firms to short-term changes in the prices of competing imported goods (such as those caused by variations in exchange rates), we find that MNEs are likely to be a source of stability in domestic employment. On the other hand, MNEs respond much more strongly than domestic firms to longer-run structural changes (or pressures for change) in comparative advantage, as reflected in import prices relative to domestic prices. In other words, it would appear that MNEs are particularly well placed to distinguish between permanent (or structural) and temporary (or cyclical) changes.

Second, multinationals do not appear to be more inclined than domestic firms to close or sell plants when faced with declining domestic demand. Thus the picture that is frequently painted of foreign-owned branch plants ready to leave Canada as soon as conditions take a turn for the worse is not borne out by the evidence.

Third – although there is some disagreement on this issue – foreign-owned firms in Canada appear to have rationalized their production facilities in response to trade liberalization and market growth in much the same manner, and to much the same extent, as Canadian firms.

Fourth, in industries experiencing rapid trade growth (such as electric and electronic equipment and chemical products) the affiliates of U.S. multinationals in Canada have grown (in terms of exports and employment) relative to those in other developed countries (Table 4). Often, these are R&D-intensive industries (non-electrical machinery and chemical products, for example) that many hope will provide the high-quality jobs desired by Canadians. At the same time, Canadian affiliates of U.S.-owned firms have become less important in industries experiencing slower trade growth. The clearest example is that of the food and kindred products industry, although in that case it is U.S. ownership of Canadian production, rather than Canadian production *per se*, that appears to have become less attractive, since Canada's share of developed-country exports increased rather than decreased during the period 1977-83.

**Table 4**

**The relative importance of Canadian affiliates of U.S.-based manufacturing multinationals, 1977-84**

| | Canadian affiliates as a proportion of affiliates in all developed countries, with respect to share of: | | | | | | Average annual growth rate of world exports, 1977-82[1] | Ratio of U.S.-parent R&D employees to total employees, 1977 |
|---|---|---|---|---|---|---|---|---|
| | Employment | | | Exports | | | | |
| | 1977 | 1984 | Change, 1977-84 | 1977 | 1984 | Change, 1977-84 | | |
| | (Per cent) | | | | | | | |
| Food and kindred products | 28.4 | 21.0 | –26.1 | 13.4 | 3.8 | –71.6 | 6.8 | 0.9 |
| Chemical and allied products | 17.6 | 19.7 | 11.9 | 5.3 | 6.9 | 30.2 | 10.9 | 4.7 |
| Primary and fabricated metals | 28.5 | 23.8 | –16.5 | 33.7 | 22.8 | –32.3 | 7.9 | 1.0 |
| Nonelectrical machinery | 11.5 | 13.0 | 13.0 | 7.6 | 9.0 | 18.4 | 9.5 | 4.3 |
| Electric and electronic equipment | 16.6 | 16.8 | 1.2 | 6.6 | 14.9 | 125.8 | 10.7 | 4.0 |
| Transportation equipment | 18.7 | 26.9 | 43.9 | 47.3 | 65.0 | 37.4 | 8.7 | 4.4 |
| All other manufacturing | 27.5 | 21.6 | –21.5 | 29.8 | 21.9 | –26.5 | 8.8 | 1.8 |

1 Measured in current U.S. dollars.
SOURCE D. G. McFetridge, *Trade Liberalization and the Multinationals*, Economic Council of Canada (forthcoming).

In the case of other manufacturing industries – including the wood, paper products, and textile industries – the employment share of Canadian affiliates of U.S. corporations have declined relative to those of affiliates in other developed countries. This development reflects a decline in the attractiveness of Canada as a production location, since Canada's share of developed-country exports fell in that category between 1977 and 1983.

Fifth, while in many industries employment in Canadian majority affiliates has tended to decline relative to that in the U.S. parent corporations, our research shows that the loss tends to be smaller in those industries where Canadian trade barriers have been lowered the most. Thus, at least on the basis of recent experience, trade liberalization is associated with the retention, rather than the flight, of U.S.-owned firms in Canada – again, a result that is not altogether consistent with public perceptions.

### *Conclusion*

The research results summarized here demonstrate that the Canadian economy can, and does, adjust to the changing conditions of international competition.

The Canadian labour market is undergoing constant change. We find that in a typical year 8 per cent of the jobs in the manufacturing sector disappear because of plant closings and contractions, while there is an increase of 9 per cent in the number of jobs created because of plant openings and expansion. Worker behaviour adds another important dimension to labour market turnover. The number of worker-initiated moves is equal, in a typical year, to at least 10 per cent of the labour force in the manufacturing sector. This excludes temporary movement. The labour-market turnover experience in trade-sensitive industries is no exception. Furthermore, studies of worker mobility in individual industries suggest that the constant change is associated with considerable mobility between industries and occupations, although older workers or those living in communities with a narrow industrial base may experience particular adjustment problems.

We realize that we have no measure of the hardships associated with job change and job loss, but our findings do give us a context within which to prepare for expected structural changes.

The evidence also suggests that Canadian- and foreign-owned firms often respond to the pressures for change in

much the same way. Where differences do arise, however, the presence of foreign-owned firms appears to enhance, rather than diminish, the ability of the Canadian manufacturing sector to adjust to the pressures for change. Finally, the Canadian affiliates of U.S. firms tend to be gaining employment relative to affiliates in other developed countries in those R&D-intensive industries where many would claim Canada's comparative advantage should reside. The major implication of these results is that a separate adjustment policy based on the country of ownership of firms is not warranted.

## 4 Sectoral Adjustment Policies

We have shown in the preceding section that a substantial amount of adaptation is continuously taking place in the Canadian economy as individuals and firms respond to the pressures for change. Framework policies accommodate and facilitate this ongoing adjustment. In a few cases, however, the pressures for change are judged to impose an intolerable burden of adjustment on particular regions, industries, and/or groups of workers. In these cases, governments intervene by adopting and implementing sector-specific policies.

Have these sectoral interventions promoted or delayed adjustment? Have they complemented or obstructed the framework policies? We shall be very careful, in answering these questions, to draw a distinction between the stated objectives of a sectoral policy and its actual implementation or evolution. There is, as we shall see, many a slip between the cup and the lip.

We focus our attention on three policy instruments that have been used to assist industries adversely affected by the pressures of international competition:

- special import measures, by which we mean quantitative limitations on the volume of specified goods that can be imported into Canada from all countries (global quotas) or from selected countries (bilateral restraints, or "voluntary" export restraints);

- firm and industry subsidies, which are usually aimed at modernizing an industry's capital equipment so that it may better compete with overseas firms; and

- labour adjustment policies, which attempt to encourage the re-employment of workers by providing financial assistance for training and mobility, as well as income maintenance for older workers who have exhausted their unemployment insurance payments and have little prospect of re-employment.

The industries that we have selected for analysis are those in which the three policy instruments have been most widely used over the past 10 to 15 years: textiles and clothing; footwear; automobiles; shipbuilding; and pulp and paper. Figure 2 summarizes the major features of each type of instrument as it was used to assist the five industries.

### *Objectives*

The promotion of adjustment was a stated objective – often the only objective – of each of the sectoral policy measures that we examined. Figure 3 gives examples of various program objectives. They are all consistent with the "positive adjustment" type of policy that we described in Section 2.

Special import measures were intended to provide a "breathing space" during which an industry under pressure could make the changes necessary to meet new international competition head on. A sudden surge in imports can wreak havoc on domestic producers, with adverse consequences for both labour and capital. When temporary quotas are introduced, the industry is given time to respond. An import surge may signify that Canada has lost its comparative advantage in a particular industry. If that is the case, some firms and their workers may choose to seek opportunities elsewhere, while other firms may decide that their best course of action is to rationalize and revitalize their operations in order to take on the new competition. The breathing space afforded by the temporary import restraints provides an opportunity for firms and workers to consider their options and take the appropriate action. From this perspective, the quotas should facilitate gradual adjustment, both by staving off any potential, socially harmful consequences (increased unemployment, in particular) and by giving firms and individuals time to adjust.

Subsidies, the second sectoral measure, were generally designed to encourage additional investment so that Canadian producers could improve their plant and equipment and enhance their ability to compete with foreign rivals. Subsidies were provided, for example, when the existing stock of machinery and equipment in a Canadian industry was old and inefficient compared with that used by its major competitors abroad. The subsidy was intended to cover part of the cost of re-equipment and to be just enough to act as a catalyst for new investment, enabling the Canadian firm to compete successfully in the domestic market or even on foreign markets.

**Figure 2**

**Adjustment policies aimed at selected industries in the Canadian manufacturing sector**

| | Pulp and paper industry | Shipbuilding industry | Footwear industry | Textile and clothing industry | Automobile industry |
|---|---|---|---|---|---|
| Policy instrument: | | | | | |
| Firm and industry subsidies | The Pulp and Paper Modernization Program (PPMP) was a federal/ provincial subsidy program primarily designed to encourage the modernization of mills in eastern Canada. The PPMP only funded a proportion of the eligible modernization expenditures. The mills that received assistance accounted for approximately 80 per cent of capacity in eastern Canada. Governmental funds expended totalled $542 million over the period 1979-84. The program contained provisions to ensure that the funds were expended on Canadian supplies. Consequently, among the principal beneficiaries of the program were the pulp and paper machinery and equipment manufacturers. Essentially, all those who applied received funding. The program was jointly administered by the Department of Regional Industrial Expansion and the respective provincial governments. | The Shipbuilding Industry Assistance Program (SIAP) was introduced in 1975 by the federal government to encourage the industry to become more competitive and thus promote stable employment. The program consisted of two parts: a subsidy for new vessel construction; and a subsidy for yard modernization, related directly to the subsidy granted for new vessel construction. In each case, the subsidy financed only a portion of the eligible costs. The program also contained a Canadian-content requirement. Over the period 1975-85, approximately $480 million was spent, with $426 million being directed to vessel construction. Although the program ended in 1985, unused modernization credits remain to be spent. The program originally was intended to gradually reduce the vessel subsidy, but this was not achieved. As with PPMP, virtually all applicants received a new vessel subsidy. The program was administered through the Department of Regional Industrial Expansion. Prior to the introduction of SIAP, the industry had benefited from two sector-specific subsidy programs since 1961. Although SIAP has been discontinued, the industry | The Canadian Industrial Renewal Program (CIRP) was introduced in 1981 by the federal government and terminated in 1986. It applied to the textile, clothing, and footwear industries. It was designed to create new employment in communities affected by industrial adjustment; to help displaced workers to take advantage of new employment opportunities; to assist the modernization of viable firms in the textile and clothing industries; and, at its conclusion, to encourage a reduction of the reliance on quantitative import barriers. Over the period 1981-86, CIRP spent approximately $364 million on modernization and restructuring, as well as new employment creation in certain communities. Most of the expenditures for labour assistance were under existing government programs. Unlike SIAP or PPMP, some firms applying for CIRP grants were rejected. For example, under the modernization and restructuring part of the program 57 per cent of the applications were rejected. In part, for this reason, all the programs administered under CIRP (apart from the labour program) were administered by an arm's-length agency, the Canadian Industrial Renewal Board. | | |

still receives special assistance via an increase in tariff levels in 1983 and via government procurement, which now accounts for a very significant share of new ship construction.

| | | | |
|---|---|---|---|
| Special import measures (quantitative restraints) | Global quotas were imposed on footwear between 1977 and 1985; the quota on women's and girls' footwear will be phased out in 1988, while the quota on leather footwear was removed between November 1981 and July 1982. The quotas applied to all countries. They were imposed in 1977 only after the Canadian Import Tribunal had found that imports were causing "serious injury." The 1984 mandate given to the CIT by the government was intended to lead to the elimination of the quota. These actions were all taken under Canada's GATT obligations. | The Multifibre Arrangement (MFA) is an international agreement under GATT that allows an importing signatory country to apply quantitative restrictions on textiles and clothing when it considers them necessary to prevent "market disruption." The MFA provides a framework for regulating international trade in textile and clothing. It provides, among other things, standards for determining market disruption, minimum levels of import restraints, and annual growth of imports. Since an importing country may impose such quotas unilaterally to restrict rapidly rising textile imports, many important textile-exporting countries consider it advantageous to enter into bilateral agreements with the principal importing countries. The MFA went into effect on 1 January 1974; it was renewed in December 1977, in December 1981, and again in July 1986, for five years. It succeeded the long-term agreement on International Trade in Cotton Textiles (known as "LTA"), which had been in effect since 1962. Whereas the LTA applied only to cotton textiles, the MFA now applies to wool, man-made (synthetic) fibre, silk blends, and other vegetable-fibre textiles and | In 1981 the government of Canada announced the introduction of an arrangement or understanding with Japan on voluntary export restraints (VERs). This limited the number of automobiles exported from Japan to Canada. It has been renegotiated annually. However, at the present time it would appear that while there is no formal arrangement, officials of both countries do "monitor" export levels. |

(cont'd)

**Figure 2 (concl.)**

| | Pulp and paper industry | Shipbuilding industry | Footwear industry | Textile and clothing industry | Automobile industry |
|---|---|---|---|---|---|
| Special import measures (quantitative restraints) | | | | apparel. In Canada, the Textile and Clothing Board, created in 1971, frequently determines "market disruption" and is called upon to present wide-ranging reports on the textile and clothing industries. | |
| Labour adjustment measures | A number of industry/community designations were made for this industry. This meant that those eligible could benefit from the same income maintenance and re-employment programs that are described for footwear workers in the period 1981-86. To be designated, the industry had to be undergoing structural change that would result in significant loss of employment in the community concerned. The designation could last for a maximum of two years during the period 1981-86. | The shipyard at Tracy/Sorel, Quebec, was offered the same labour adjustment program as indicated for the pulp and paper industry. | Income maintenance was provided for older workers who had exhausted their unemployment insurance. The level of income maintenance was linked to the employee's years of service and the number of hours worked per year (1978-86). Re-employment programs were designed to encourage workers to move to new locations or retrain, and temporary employment opportunities were designed to maintain a worker's skills (1981-86). In both instances, the benefits applied to footwear workers, no matter where they were located, for all of the period indicated. These re-employment opportunities were essentially enhanced benefits of the existing labour adjustment programs. | The textile and clothing sector received the same benefits as the footwear workers, except that the income maintenance program dated from 1971, not 1978. | A number of communities in the automobile industry received the same benefits as those described for the pulp and paper industry. |

SOURCE Various government documents.

**Figure 3**

**Policy objectives of sector-specific adjustment policies: Some illustrative examples**

| | |
|---|---|
| Voluntary export restraints on automobiles | The objective of VERs on automobiles from Japan was stated by the Minister of Regional Industrial Expansion in 1987 as follows:<br><br>*The Canadian government has consistently stressed that the automotive industry must adjust to these [NICs and Japan] international competition factors and must introduce the new technologies and work practices that will make our industry truly competitive in the long run. However, we recognize that during the transition period, while the industry adapts, it must be provided with a breathing space, and disruption of the Canadian market should be minimized, to ensure the financial health and long-term viability of this important sector.* |
| Shipbuilding Industry Assistance Program | Excerpt from "Minister's Statement on Shipbuilding Assistance Program," a press release dated 5 March 1975:<br><br>*Its objective was to propose initiatives to assist the industry to improve substantially its internationally competitive position . . . to maintain stable employment with less reliance on government assistance in the future.* |
| Pulp and Paper Modernization Program | In the administration of the PPMP, a number of agreements were signed between the federal and various provincial governments. In the Canada-Quebec Agreement, the following clause appears:<br><br>*Purpose*<br><br>. . .<br><br>*(2) This Agreement makes possible the establishment of a federal-provincial assistance program for the modernization of the pulp and paper industry in Quebec.*<br><br>*(3) Without restricting the meaning of the foregoing, the purpose of this Agreement is, more specifically, to offer financial assistance to pulp and paper companies eligible for the program, to enable them to:*<br><br>*a) modernize their facilities with a view to reducing production costs;*<br>*b) install equipment that will help protect the environment and conserve energy.* |
| Mandate of the Canadian Import Tribunal inquiry into footwear | Excerpt from Order in Council P.C. 1984-2087, dated 14 June 1984:<br><br>*Therefore, Her Excellency the Governor General in Council, on the recommendation of the Minister of Finance and the Minister for International Trade, pursuant to section 16.1 of the Anti-dumping Act, is pleased hereby to direct the Anti-dumping Tribunal [the former name of the Canadian Import Tribunal] to undertake forthwith an inquiry in respect of the importation into Canada of footwear and skates in order to:*<br><br>*a) determine whether such goods, other than those the main component of which is rubber, in respect of any sectors of the industry thereof, in the absence of special measures of protection, are being imported, would be imported or would likely be imported into Canada at such prices, in such quantities and under such conditions as to cause or threaten serious injury to Canadian production of like or directly competitive goods;* |

**Figure 3 (concl.)**

| | |
|---|---|
| Mandate of the Canadian Import Tribunal inquiry into footwear | *b) examine the extent to which the Canadian footwear industry has restructured since the 1981 Report of the Anti-dumping Tribunal Respecting the Canadian Footwear Industry and the extent to which the industry has improved or has made realistic plans to improve its competitive position against imports;*<br><br>*c) taking into account the various elements that affect the retail price of footwear in Canada, examine what impact the import quotas on footwear have had on the operations and levels of activity of importers, wholesalers and retailers of these products in Canada and on the prices paid for footwear by Canadian consumers;*<br><br>*d) consider the future competitive prospects of the industry, including identifying areas where the Canadian footwear and skate industries are, or could become, competitive with imports in the domestic market without special measures of protection, having particular regard, as appropriate, for differentiations among the various product lines now produced in volume in Canada, and the relative strength of import competition in these specific product lines or in like or directly competitive products; and*<br><br>*e) taking into account the above, and in the event of a determination of injury or threat thereof, recommend a formula by which the special measures of protection could be phased out through a progressive liberalization process covering a period of not more than three years, by which time the Canadian industry would be required to face international competition without special measures of protection.*<br><br>*Her Excellency the Governor General in Council is further pleased to direct that the Anti-dumping Tribunal submit its report within 12 months of the date of referral.* |

Finally, labour adjustment measures were adopted to encourage and assist workers to adjust in industries adversely affected by international competition. The programs adopted in the 1970s were applicable to all workers in selected industries – textiles, clothing, and footwear. But some of the programs of the 1980s were targeted specifically at workers in designated industries in local markets – i.e., in industries undergoing a significant employment loss as a result of important economic adjustment. Unlike the Canada-wide designations of the 1970s, which were linked to international competition, the industry/community designations were not related to any one cause.

The official objectives of the sectoral adjustment programs thus tended towards the "positive adjustment" end of the policy spectrum and its associated efficiency and equity rationales for government intervention. They were intended to encourage and facilitate adjustment; to be temporary; and, in some instances, to be phased out gradually. They were clearly meant to strengthen or supplement the framework policies.

### *Implementation*

The reality of policy implementation was different from the intentions expressed in ministerial statements, press releases, and speeches, or in the international treaties to which Canada is a signatory. Instead of promoting "positive adjustment," the implementation of sectoral assistance programs (with the exception of those directed at the footwear industry) has tended to delay adaptation by giving in to the pressures of the "new protectionism."

The breathing space that special import measures were supposed to provide to encourage adjustment has typically been not temporary but of considerable duration. For example, although Canada's bilateral understanding with Japan on voluntary export restraints on automobiles has been renewed on a number of occasions since its inception in 1981, at no time was an appropriate termination date specified. A similar situation has occurred with the Multifibre Arrangement (MFA) – a multilateral accord signed in 1974 within the GATT framework, which allows countries

(usually a low-wage producer and an OECD importer) to enter into bilateral agreements governing the level of trade in textile products. Article (1) of the MFA states that its objective is to "achieve the expansion of trade, reduction of barriers to such trade and progressive liberalization of world trade in textile products, while at the same time ensuring the orderly and equitable development of this trade and avoidance of disruptive effects in individual markets." Since its inception, however, the MFA has become progressively more restrictive. Moreover, imports to Canada of textiles and, in particular, of clothing have increased despite the bilateral agreements made under the MFA. Furthermore, the MFA (which maintains protectionist measures dating from the 1960s against imported cotton textiles) has not been phased out as originally intended but has been renewed three times and is currently slated to expire in 1991. This is not to deny, however, that considerable adjustment has occurred in these industries for other reasons. In textiles, for example, there has been considerable interfibre substitution, and the industry has become increasingly capital-intensive.

The actual implementation of the three subsidy programs that we studied also fell well short of their stated objective of encouraging positive adjustment. In the shipbuilding industry, the subsidy program has been replaced by a series of other policy measures designed to protect the industry from the winds of international competition. Even during the life of the Shipbuilding Industry Assistance Program (1975-85), the value of the subsidy, which was supposed to be reduced gradually, was increased on a number of occasions. In the case of textiles and clothing, although the subsidy program ended in 1986, the promised reduction in quantitative restraints has not taken place. Instead, Canada assented to the 1986 renewal of the Multifibre Arrangement, which further restricted imports. Finally, although the Pulp and Paper Modernization Program was discontinued in 1984, the federal government continues to subsidize the industry under other programs. Far from acting as a catalyst for new investment, the subsidies have brought in little additional capital to modernize plant and equipment in any of those industries.

The labour adjustment policies were developed to respond to the problems identified in Section 3 – namely, that adjustment is likely to be more difficult for older workers and for workers employed in areas with a narrow industrial base. The preretirement and re-employment programs were designed to complement the breathing space provided by the quantitative restraints and to facilitate any retraining needed because of plant and equipment modernization. But, as we have seen, import restraints and subsidies were implemented in a way that retarded adaptation rather than promoted it. As a result, labour adjustment programs were given a very limited opportunity to demonstrate their usefulness.

The only bright spot in our examination of policy implementation has to do with the use of quantitative restraints in the footwear industry. Here, implementation was generally consistent with the "positive adjustment" objective. The quotas were announced as temporary, and they were indeed phased out. In fact, the government explicitly chose the phase-out option in its 1984 reference to the Canadian Import Tribunal (see Figure 3). The Tribunal asked the right questions, undertook the appropriate analysis, and delivered its report in a timely and relevant fashion. The footwear experience is an example of Canada respecting its GATT commitments regarding the procedures and timetable to be followed when imposing global quotas against imports that are causing serious injury.

### *Rhetoric vs. Reality*

Thus it can be seen that while the objectives of the special import measures and subsidies were close to the "positive adjustment" end of the policy spectrum illustrated in Figure 1, their actual implementation tended to bring them nearer to the "new protectionism" end. The demands for protection against foreign competition, and the political pressures arising from those demands, were the dominant factors in determining this outcome on the policy spectrum. Why has policy implementation so seldom been consistent with policy objectives?

Two factors may explain the gap between rhetoric and reality. First, the policy may not have had a reasonable chance to promote adjustment because it was poorly conceived. The underlying analysis may have been faulty, or the policy selected may have ignored a correct analysis because it pointed to an unattractive adjustment option. Second, a program may create incentives that favour its continuation once it has been put into place, quite independently of the reasons initially invoked for adopting it. We address both questions in the following pages.

### *Defining the Problem*

For the implementation of a policy to be consistent with its stated objectives, the proper questions have to be asked, both about the adjustment problem and about its solution:

- Is there a problem? If so, of what nature? How can we measure it? What caused it?

- Is there a need for government intervention? What form should it take? What are the costs and benefits of each available instrument or form of intervention?

- What criteria should be used to distinguish between the various policy alternatives?

- How long should the intervention last?

- What benchmarks should be laid down in advance to determine the eventual success or failure of the program under consideration?

With one notable exception – the inquiries conducted into the footwear industry by the Canadian Import Tribunal (particularly as reflected in the 1984 terms of reference given to the Tribunal in its 1985 Report) – the right questions do *not* appear to have been asked when government was considering measures to facilitate adjustment in the five industries threatened by foreign competition.

The current policy process does not appear to encourage systematic reviews of past, present, or proposed sectoral policies for trade-sensitive industries, in the course of which the right questions would be raised and thoroughly investigated. The enabling legislation for subsidy programs is often very vague, allowing wide latitude in their implementation. In the case of the Pulp and Paper Modernization Program, this latitude attracted the attention of the Law Reform Commission of Canada, which, after considering the statutory authorization, commented that "the statutorily proclaimed objective is extremely vague and it provides a wide mandate for the program, but little direction as to what is and is not eligible under the program." That is perhaps why the pulp and paper-making machinery and equipment industry was one of the important beneficiaries of the program. The program sought to encourage the use of Canadian equipment in pulp and paper mills despite evidence that the domestic machinery industry was experiencing difficulty in competing with foreign supplies.

In the case of the voluntary export restraints on Japanese automobiles, we were unable to find any statutory authorization for the federal government to negotiate these particular limitations on trade; hence an evaluation of whether such a program has attained its objective is difficult. The government did appoint a task force, co-chaired by representatives of the United Automobile Workers Union and of the Automotive Parts Manufacturers' Association, to look into the question. But it is difficult for a task force composed of interested parties to provide objective analysis when so much is at stake.

*A Credible Timetable*

When the government decides, for whatever reason, to assist an industry in a way that will shield it from foreign competition, expectations about the duration of that assistance are likely to affect the adjustment decisions made by workers and employers. If the assistance program has a clearly specified terminal date that is expected to be enforced, the industry will be spurred towards actively adapting, because it knows that in the near future the forces of foreign competition will reappear. If, however, producers and workers expect the program to be prolonged or, in the event of its termination, to reappear under another form, they will rationally incorporate those expectations into their behaviour, so that the incentive to adjust will be reduced and adjustment will be retarded. To the extent that foreign suppliers improve their efficiency and cost competitiveness faster than Canadian firms, the scale and scope of the required adjustment will increase rather than decrease. This will further strengthen the demand for continued protection.

Our examination of the implementation of sectoral policies, which is detailed much more fully in our research report and in several background studies, suggests that governments have a serious credibility problem. In a number of cases – including shipbuilding, and textiles and clothing – a terminal date, or a phasing-out mechanism, was specified when the program was announced, but the announcement was belied by events, as noted above and as described in Figure 2.

In other cases (such as automobiles), no credibility problem exists, since no date was ever set for the termination of voluntary restraints on Japanese car exports to Canada. Clearly, if the government's commitment to terminating quantitative restrictions or subsidies is not credible or nonexistent, then individuals and producers will set their expectations accordingly, and adjustment will be retarded.

*Benefiting from the Breathing Space*

Quantitative restraints are meant to provide a breathing space during which firms and workers can adjust by rationalizing or by moving to another industry or firm. Whether adjustment will actually be promoted depends upon a number of factors. We have already mentioned the importance of having a credible timetable for phasing out sectoral assistance programs. A second important factor is whether the quota is global (applying to imports from all sources) or selective (applying to only one or a few countries).

Quotas generally restrict the level of imports, thus causing the price of the imported good to be higher. In the case of a selective quota, if the government of a country targeted by the quota allocates it among its producers, they will normally be able to realize a higher return on their exports than they would otherwise. For example, it has been estimated that Japanese automobile companies garnered as much as an additional US$1 billion in profits in 1984 because of voluntary export restraints on sales to the United States. As foreign producers receive higher prices because of import restraint measures, they will be able to strive even harder to maintain and improve their competitive advantage over their domestic competitors. This widening gap may discourage domestic producers from using the breathing space to revitalize their operations. Global quotas are much less likely to give rise to that problem. They are typically assigned to importers, manufacturers, and retailers in Canada, who may seek their import sources anywhere in the world. Hence the benefit of the higher import prices will not accrue to producers located in other countries but, instead, may accrue to Canadian manufacturers, who can use the funds to promote adjustment.

Selective quantitative restraints can suffer from another weakness. They usually target low-cost producers, and if the prices of their goods rise significantly in the Canadian market, there will be an incentive for potential producers in countries not restrained by quotas to manufacture those goods and ship them to Canada. The response from new suppliers is likely to be faster in industries such as clothing and footwear, where entry is relatively easy, than in the automobile industry, where entry requires major investments.

A selective quota that leads to the arrival of competing imports from new suppliers may well defeat the purpose of the breathing space. Instead of encouraging domestic firms to adjust, it will likely lead to requests for bilateral restraint agreements with the new suppliers. That is what happened with automobiles and with textiles and clothing under the Multifibre Arrangement. If production costs in the countries not restrained by quotas are higher than in the restrained ones and the selective quota makes it profitable for the higher-cost producers to export, an inefficient allocation of resources will result, from a global point of view. Global quotas that just set a ceiling on imports from all sources do not suffer from these shortcomings.

A third problem with quotas, whether global or selective, is upgrading. When the size of the quota is set in volume terms, as it usually is, there is an incentive for exporters to shift to those categories of the restricted good where they can earn the highest profit margins. Such upgrading is much more likely in differentiated products such as automobiles, footwear, and clothing than in relatively homogeneous goods. Upgrading usually entails shifting to the production of more sophisticated products in terms of styling, design, or technology. This will usually result in the imports penetrating sectors of the market in which Canadian producers previously had an advantage. For example, in the case of automobiles, it has been argued that the agreement with Japan on voluntary export restraints actually accelerated the movement of Japanese manufacturers into the mid-size category, in which North American manufacturers traditionally held a dominant market share. Hence, in contrast to their original intent, quotas may shorten the breathing space by increasing the rate at which imports penetrate that sector of the market where domestic producers felt most secure.

The critical question is whether bilateral or global restraints lead to faster upgrading. The answer will depend upon a number of factors, including the importance of the countries subjected to selective restraint; their ability to upgrade their product; the competitive threat from the non-restrained countries; and the size and distribution of the benefits realized in the exporting country. If producers who are restrained by a selective quota receive the benefit of higher prices, are able to upgrade their products, and experience competition from countries not restrained by quotas, then upgrading may occur more quickly than if producers were restrained by a global quota. In our review we see evidence of upgrading in the case of selective quotas (e.g., automobiles) but much less evidence in the case of global quotas (e.g., footwear). Whether this is due to the nature of the product subject to quota, to the particular way in which the quota was administered, or to the target country is more difficult to say. In any event, the shorter the period during which the quota (whether bilateral or global) is in effect, the slower the upgrading process is likely to be.

### *Incentives to Adjust*

Quotas, whether bilateral or global, also allow domestic producers to push prices higher than they would be in the absence of trade restraints. Naturally enough, once firms become used to these higher prices, there is an incentive to maintain them whether successful adjustment takes place or not. Hence, no matter what rationale was used to support the import restraint policy initially – economic efficiency, equity, or political considerations – once the benefit is created, a number of different groups, including the quota holders, are likely to join forces to perpetuate the quotas. Thus one of the reasons that quantitative restraints last for longer, not shorter, periods is that their very creation leads to support for their continuation.

### *Conclusion*

The broad experience of adjustment documented in Section 3 and the experience of sector-specific policies reviewed in the preceding pages confirm our view that the positive-adjustment approach is the right one. Yet experience shows that this approach is difficult to implement by means of sector-specific policies. Typically, sectoral policies have retarded rather than promoted adjustment. They have also had a rather low payoff. For example, while the preservation of employment has been a frequent, if unstated, goal of all these policies, the results have usually been quite marginal: the footwear quotas increased employment by 2.1 to 4.4 per cent (by 350 to 700 jobs); in the case of automobiles, of the increase in industry employment between 1982 and 1985, 12 per cent (3,180 jobs) was due to the voluntary export restraints on Japanese cars. But quantitative restraints and subsidy programs also provide assistance to firms and workers who would not necessarily leave the industry if the programs were gradually phased out but would most probably face a fall in income because of the increased competition. This explains the apparent paradox that programs with only a marginal job impact still command considerable support from workers as well as from firms.

We do not reject sectoral measures as a valid and potentially useful element of adjustment policy; but the Canadian experience that we examined suggests that a number of corrective steps must be taken to ensure that policy implementation conforms to positive-adjustment intentions.

## 5 Principles for Adjustment in an Imperfect World

In this final section, we present a set of principles to guide government in managing adjustment and, in particular, in dealing with the demand for intervention generated by competitive pressures. As we have seen, governments have to act in an imperfect world, facing constraints inherited from the past and pressures from numerous groups in society. Nevertheless, they have considerable latitude in how they manage adjustment, and their decisions have far-reaching consequences.

In previous sections, we summarized the results of our examination of the way in which Canadian firms and workers are constantly adjusting and on our investigation of the working of special sectoral adjustment policies. Our findings, reported in much more detail in our research report, lead us to conclude that the Canadian marketplace, structured by sound framework policies, can generally be counted upon to provide signals – prices, shortages, surpluses – that point labour and capital in the direction of positive adjustment.

This does not mean, of course, that the market mechanism has no shortcomings – our discussion of training in Section 2 suggested imperfections in the field of training, for example – or that the adjustment path is always smooth and painless.

Our findings do, however, lead us to give priority to adjustment through the working of framework policies (which include, as we shall see, labour market policies) and to consider special sectoral policies as exceptions, to be introduced only under particular conditions and subject to clear evaluation.

This leads us to our first principle for adjustment:

**1 We recommend that governments make every attempt to develop, maintain, and strengthen framework policies that facilitate and promote the movement of resources from less-productive to more-productive uses in the way that is least costly to society.**

**Where sector-specific policies are adopted, they should respect the same principle.**

### *Sectoral Policies*

Our analysis of sectoral adjustment-assistance policies suggests that while their stated objective was the promotion of adjustment to change, their actual impact has retarded it. Good intentions were clearly not enough. Since the objectives and the rhetoric inspiring those policies were, by and large, consistent with the "positive adjustment" end of the policy spectrum, our suggestions and recommendations are designed to make implementation consistent with objectives.

#### *Assistance for Workers, Not Firms*

In our general discussion of the relative merits of labour and firm adjustment-assistance policies in Section 2, we unequivocally favoured programs to support workers rather than firms. Our examination of the way in which firm assistance programs have worked in practice (in Section 4) confirms this view.

Subsidies granted to firms and industries to modernize their capital equipment have not promoted adjustment,

despite their aims. Although it is theoretically possible to promote incremental private-sector investments through subsidies, our review of capital subsidies led to the following conclusions: 1) in general, the expenditure of modernization subsidies was not incremental – that is, the subsidies did not typically encourage firms to undertake extra investment; and 2) the subsidy programs could not be justified on either efficiency or equity grounds. This was true whether the subsidy program was administered by a government department or an arm's-length agency, whether the targeted industry was facing international competition either in Canada or in export markets, and whether the program specifically included incrementality in its objectives or not.

In contrast, there is a strong argument for government intervention to help workers adjust. The design of the labour adjustment measures that we examined was consistent with the "positive adjustment" rationale and objectives. So far, these policies have only had a limited opportunity to demonstrate their usefulness because other sectoral programs (quantitative restraints and firm subsidies) were actually retarding adjustment.

Thus, as our second principle for adjustment,

**2 We recommend that when a particular industry or firm is suffering adverse consequences because of international competition, governments respond by adopting labour adjustment policies rather than by granting subsidies to firms and industries so that they may modernize their capital equipment.**

Our recommendation reflects the fact that resources are scarce. Canada cannot afford capital modernization subsidy programs with a low payoff. However, the recommendation refers only to capital modernization subsidies provided to particular industries adversely affected by international competition. Other forms of government assistance that are generally available to business (including R&D support and assistance to small businesses), which form the great bulk of firm and industry support, were not examined in our research.

*Efficient Use of Quotas*

Quota restraints provide both labour and capital with time to adjust. To the extent that an import surge is likely to cause "serious injury," there is a rationale for giving industry a breathing space in which to adjust. Consequently, we support the use of quotas to assist industries adversely affected by international competition, provided that Canada corrects the mistakes of the past. Thus, as our third principle,

**3 We recommend that, where import quotas are used, they should be:**

- **global, not bilateral;**
- **temporary, not permanent;**
- **gradually phased out (degressive), not constant; and**
- **subject to a preset termination date.**

These guidelines flow directly from our conclusions in Section 4 regarding lack of government credibility in establishing phase-out dates, the need to use the breathing space provided by quotas to promote rather than retard adjustment, and the advantages of global over bilateral quotas. It should be noted that global quotas are not the blunt instrument they might appear to be. While a global quota is directed at all foreign sources of supply, the restriction usually applies to a particular commodity and, in some instances, even to a particular price range. A global quota can thus be placed on a chosen range of goods as long as the range is not too narrow – in particular, as long as it is not so narrow as to be a substitute for selective restraints.

We also note that, although our attention has been confined to three instruments of government intervention that have been used to support a select group of industries, there are other measures that address particular causes of disruption from imports. Canada can countervail subsidized exports and impose antidumping duties on dumped goods, for example. In this Statement, we do not deal with these mechanisms, which are quite distinct from the three instruments we studied, but we note their availability to relieve firms suffering from import-related disruption under certain circumstances.

In Recommendations 4, 5, 6, and 7, presented in the following paragraphs, we flesh out the principles for the proper application of quotas, which we believe to be the appropriate instrument for dealing with import disruption on a sectoral basis. However, some of the principles outlined below (particularly in Recommendations 4 and 5) could be applied to the adoption of other sectoral policies, such as subsidy programs, should governments persevere in using them.

*Defining the Problem* — Good public policy requires that the right questions be asked, that the costs and benefits of government intervention be evaluated, and that alternatives be considered. This should be done through documents

that are easily accessible to policy makers, elected representatives, and the public. Once a clear, concise, and well-defined statement of the problem, as well as a full assessment of the costs and benefits of the proposed corrective measures, becomes an important part of the debate over the introduction and implementation of sectoral policies, those seeking (and opposing) such policies will be called upon to argue their case. Hence,

**4 When governments introduce sectoral policies (in particular import quotas), to assist industries or firms suffering from the adverse consequences of international competition, we recommend:**

- **that they undertake a thorough evaluation of the problem to be addressed, as well as of the costs and benefits of alternative policy options, including their transparency, duration, necessity, and impact on firm-adjustment options;**
- **that they implement the preferred policy in such a way as to generate the information necessary for the retrospective evaluation of the policy; and**
- **that they make accessible to the general public, as well as to interested parties, the documents that result from both the initial and the retrospective reviews.**

**If the urgency of the situation requires a quick reaction by government the evaluation may be undertaken after, rather than before, the policy has been introduced.**

Not only will such evaluations make the policy process much more transparent; they should also help to prevent the adoption of policies that have little chance of success.

*An Independent Review* — In considering the nature of the review process required to implement Recommendation 4, we are guided by the principles laid down in our earlier report on the regulatory process (*Responsible Regulation*, published in 1979). We stated that four values should be respected in designing government intervention: informed decision making; accountability; procedural fairness; and openness. We also found that one of the problems that regulatory boards experience in respecting those values is that they frequently become captured by the very industry they are regulating. Agencies that confine themselves to a particular industry are more likely than others to be overwhelmed by its concerns and those of its labour force, and they are less likely to learn from the experiences of adjustment that may have occurred elsewhere. Accordingly,

**5 We recommend that the policy evaluation proposed in Recommendation 4 be undertaken by an independent arm's-length tribunal, whose mandate is not confined to one or a small number of industries.**

The tribunal would hold hearings and issue written reports.

*Compliance with the GATT Rules* — Being a small, open economy, Canada has much to gain from adherence by all countries to internationally agreed-upon rules governing the way in which special import measures and other trade measures – such as countervailing duties, dumping, government procurement, and subsidies – are administered. These rules are agreed upon within the GATT framework, but their enforcement depends largely on their interpretation under national legislation by each country's administrative tribunals. Large, economically powerful countries can obviously circumvent the rules or bend them to their own purposes more easily than smaller countries. The latter – Canada among them – therefore have much to gain from everyone's strict adherence to the rules. One way to encourage such adherence is for Canada itself to honour the rules.

In the case of quantitative restraints, Canada's own interests should also lead it to respect GATT rules. Article XIX of the General Agreement is the central safeguard measure – sometimes referred to as the "escape clause" – dealing with the right of governments to aid firms or industries that experience import competition difficulties unrelated to foreign subsidies or dumping. This article is generally taken to mean that if serious injury is threatened or actually caused to domestic producers, the affected country can raise tariffs, impose quantitative restrictions, or take other appropriate action. Serious injury arises from an increase in imports, usually referred to as a "surge." Any emergency action taken under Article XIX is clearly intended to be of limited duration – "for such time as may be necessary to prevent or remedy such injury."

Canada has adopted legislation designed to be consistent with Article XIX of the General Agreement. It was under this legislation that the Canadian Import Tribunal was requested by the government of the day to inquire into, and report on, whether imports of footwear were causing serious injury. The CIT is an independent, quasi-judicial tribunal that is aided in reaching its decision by both in-house and commissioned research and by a wide array of interest groups that present briefs and appear before it. For example, during the 1984-85 footwear inquiry, representations were made by both Canadian importers and Canadian producers, exporters, the Consumers' Association of Canada, and the Director of Investigation and Research of the Department of

Consumer and Corporate Affairs. Their participation enhanced the Tribunal's ability to explore a wide range of pertinent issues. It is important to note that it was the broad and comprehensive terms of reference set by the government that enabled such a wide range of views to be heard.

In our review of the use of quantitative restraints, we were favourably impressed by the manner in which the Tribunal undertook its various inquiries into the footwear industry in order to meet the serious-injury test of Article XIX and by the appropriate terms of references that the government set out for these inquiries, particularly in 1984. It accords with our recommendations for a thorough policy review by an independent tribunal, whose mandate would not be confined to one or a small number of industries.

Such reviews have been the exception rather than the rule, however. A contrasting example was the "negotiation" of restraints on automobile imports. In this case, there was virtually no public analysis of the link between the policy instrument adopted and the expected adjustment; the government-appointed industry task force did little, if anything, to advance the debate. The procedure for determining serious disruption in the textile and clothing industries has usually fallen somewhere between the CIT experience and that of the task force report on automobiles. In view of this,

**6 We recommend**

- **that *before* governments impose import quotas, they refer the matter to the Canadian Import Tribunal for a thorough policy evaluation;**
- **that *after* import quotas are imposed, governments refer the question of their continuation to the CIT for reconsideration within three years; and**
- **that *both* before and after the imposition of import quotas, the CIT hold hearings and issue a written report.**

**In case of emergency, the policy evaluation may take place while some temporary import restraint is in place.**

The procedure outlined in this recommendation is the one followed when Canada imposes quantitative restraints under Article XIX of the GATT. (In cases of emergency, the government can, under certain conditions, impose a temporary surcharge for 180 days while the CIT conducts an interim inquiry, as happened in the case of footwear in 1977.) We are recommending here that the procedure be extended to cover *all* proposed import quotas. In the event that the government ignores our recommendation to avoid the use of further voluntary export restraints, Canadians would at least be assured that their implementation would be transparent and that their costs and consequences would be properly documented.

*Linking Benefits to Adjustment* — Import quotas hold imports at a lower level than would otherwise be the case. This creates valuable commercial rights, as the price of foreign supplies in the Canadian market is higher than the world price. As we saw in Section 4, the difference is frequently captured by the quota holder. By imposing quotas, the government is essentially creating monopoly rights.

We have seen that different types of quantitative restraints affect the domestic industry in different ways. The distribution of the quota benefits between Canadians and foreigners and between different classes of quota holders also varies, depending on the criteria used in allocating the quota. Global quotas imposed in conformity with GATT rules offer one example of the distribution of benefits. These quotas are usually allocated on a historical basis to firms that have previously imported – retailers, wholesalers, and manufacturers, as well as professional importers. Typically, a base year is selected, and all importers of record that year receive the right to import a percentage of their base-year imports. In the case of footwear, these imports can be purchased from any country. Officials from the Department of External Affairs administer the quotas: they determine their initial allocation and decide on subsequent changes, such as increases over the base level (some of which may be allocated to new holders).

A different pattern of distribution arises from bilateral restraints under the Multifibre Arrangement and from voluntary export restraints (VERs) on automobiles. In these cases, Canada negotiates the overall level of each country's quota for each restricted commodity, although the rules and framework in each case are different (see Figure 2). The exporting country is then responsible for allocating the quotas among its exporters.

One of the characteristics of voluntary export restraints and bilateral restraints under the MFA is that quotas (and their associated benefits) go to the foreign country in return for its agreement to limit exports to Canada. Where many commodities and countries are involved, negotiations can be very time-consuming. By awarding the financial benefits to the exporting country, Canada can offer it an incentive to negotiate restraint agreements.

In Recommendation 3, we favoured global quotas over bilateral restraint arrangements such as those which are

permissible under the MFA. The question that arises is: How should the quotas be allocated? One alternative to the present system – one that is consistent with Canada's obligations under the GATT – is to auction off the quota. Under this system, the government would continue to set an import ceiling but, rather than have the Department of External Affairs verify importers of record for a given base year, the quota would be divided into standard lot sizes and auctioned off. Quotas could be set for a three-month period, for a year, or for a longer period, depending on the nature of the commodity and on the normal cycle of orders.

The auctioning of quotas offers several advantages over the present allocation method:

- It ensures greater transparency. Because quotas would be given a dollar value – $3 per pair of shoes or $1,000 per automobile, for example – import restraint policies would be much more visible, giving voters and elected representatives a clear idea of their cost.

- Existing quota allocations to importers, producers, retailers, and others follow historical import patterns. This excludes or discourages new entrants, potentially reducing competition in the industry. If quotas are auctioned, the windfall gain from the quota will accrue to the government. This means that the quota holder cannot use it as a competitive advantage to shut out new entrants.

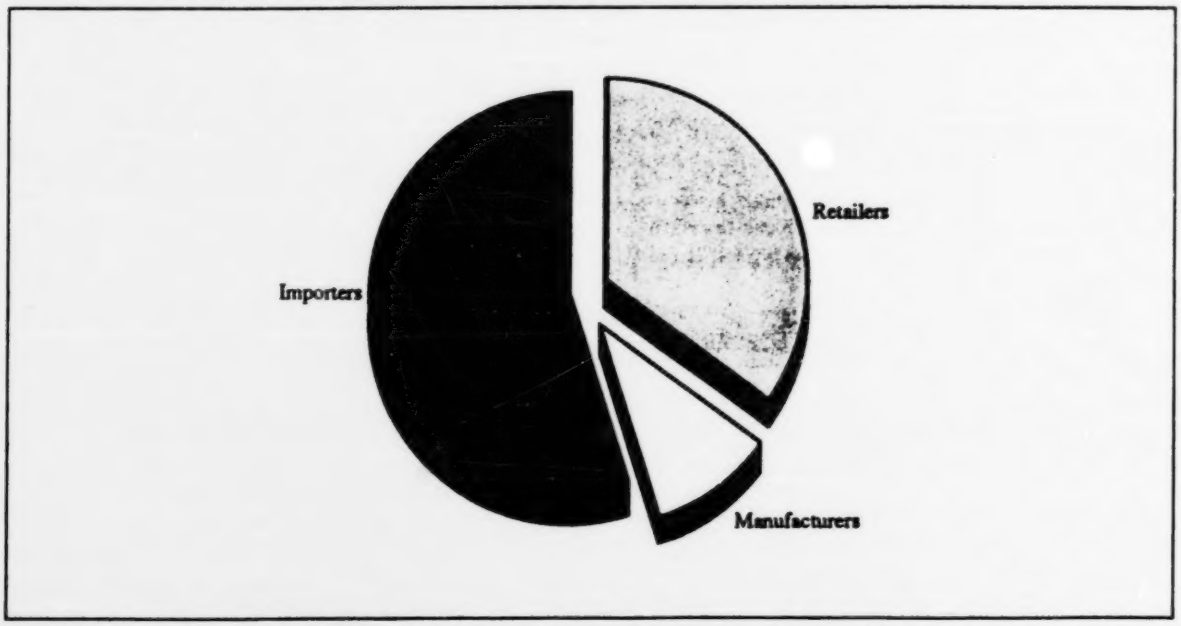
- The benefits of existing global quotas frequently go to importers and retailers (Chart 10) rather than to the manufacturers and workers who need to adjust to competition. Under the auction system, the benefits would accrue to the government, which could then use the funds to respond to adjustment needs.

- Setting up auctions for quotas would provide a clear indication of their tariff equivalent. This would raise the possibility of converting the quota to a tariff – generally considered to be a more efficient instrument of trade policy.

There are some perceived problems with quota auctions, but we do not consider any of them to be insuperable. First, the novelty of the idea may suggest impracticability. But quotas are already auctioned off for a number of goods in Australia and New Zealand; and in the case of some bilateral

**Chart 10**

**Benefits of holding footwear quota, by category of quota holder, Canada, 1980[1]**




1 Only benefits accruing to quota holders are considered here. Manufacturers also benefit, however, because their domestic production is protected. When that fact is taken into account, the share of manufacturers becomes more important than that of retailers, while the share of importers remains the largest.

SOURCE Canadian Import Tribunal, *Report Respecting the Canadian Footwear Industry* (Ottawa: Supply and Services Canada, 1985).

restraints under the MFA, the exporting country allows quota markets to exist. Second, the auctioning of quotas might cause difficulties for "traditional" importers and retailers. But if this is felt to be an important problem, then – initially at least – some proportion of the quota could be reserved for certain categories of buyers. Third, it could be claimed that a monopoly problem may occur if one person, or a small number of persons, controls the quotas. This problem could be overcome if no individual or company were allowed to hold more than a certain percentage. In any event, if the quotas are temporary and gradually phased out, any monopoly problem will be short-lived. Finally, some might argue that a large bureaucracy would be needed to administer and police the quota auctions; however, officials are already in place to allocate and police existing quotas; it is not clear why an auction system would require more resources.

On balance, we feel that the advantages of quota auctions outweigh their disadvantages. Indeed, according to a report prepared for the Department of External Affairs ("Allocation of global quotas to importers: Assessment of the current system and alternatives," May 1986), quota auctions would appear to overcome virtually all of the administrative, distributional, and economic efficiency problems to which the present allocation system gives rise. Accordingly,

**7 We recommend that the quota rights created under quantitative restraints, pursuant to Article XIX of the General Agreement on Tariffs and Trade, be auctioned off by the Canadian government and that the results of such auctions be published.**

The recommendation as formulated only applies to global quotas, in conformity with GATT rules. But it has also been suggested that auctioned quotas be used as an element in a proposed phase-out of the MFA, which could start when the current agreement expires in 1991. Basically, in return for phased-in guaranteed access to Canadian and other developed countries' markets by non-OECD suppliers, a developed country would be permitted to auction quotas during the phase-in period, but the quotas would be gradually expanded until they became meaningless. Then, only the tariff would remain to protect domestic producers. Such a proposal might be usefully considered by Canada and by the other signatories to the Multifibre Arrangement, perhaps as part of the *Uruguay Round* of multilateral trade negotiations under the GATT.

*Index of Protection* — Quantitative restraints are only one of a number of policy instruments that can be used to aid industry. Our discussion of sectoral assistance has shown cases where one protective instrument was substituted for another – for example, the Shipbuilding Industry Assistance Program was replaced by government procurement and a juggling of the tariff rates that effectively raised tariff protection. So there is the danger that if our recommendations concerning quotas are followed, governments may shift to the use of alternative, less transparent methods of protection. This would be more likely to happen if the evaluation of a proposed policy was expected to undermine the justification for quotas. A systematic examination of the range of instruments being used to provide assistance to a particular industry (subsidies, government procurement, tariff changes, quantitative restraints, and so on) would reveal such a shift. The results of the examination should be provided to the public, to policy makers, and to elected representatives at regular intervals. Accordingly,

**8 We recommend that the Canadian Import Tribunal publish annually, on an industry-by-industry basis,**

- **a list of the instruments currently being used to protect an industry from international competition; and**
- **an estimate of the effect of each instrument by calculating the tariff that would be required to replace it with the same degree of protection.**

Recent work at the Council on nontariff barriers suggests that the implementation of this recommendation is likely to be a major undertaking. Accordingly, the Tribunal should begin by confining its attention to a narrow range of instruments: firm and industry subsidies, tariffs, government procurement, Canadian-content rules, and quantitative restrictions. Clearly, if the government decides to use a close substitute for one of these instruments to avoid the glare of public examination, the CIT should report it.

The publication of a protection index raises a potentially important strategic consideration for trade negotiations. If Canada were to regularly publish an exhaustive list of all of its direct and indirect methods of protecting an industry from international competition, this could place its negotiators at a disadvantage in attempting to get balanced concessions from other countries where such information was not available. This concern reinforces the suggestion above that the CIT confine its attention to a narrow range of instruments. Foreign governments can collect data about the use of these five instruments relatively easily, either directly or through firms exporting to Canada. The proposed index would thus inform Canadians without weakening the hands of our negotiators.

### *Strengthening the Framework Policies*

Our recommendations for limited and well-defined sectoral policies presuppose sound framework policies. Indeed, a well-functioning market economy, operating within a properly designed set of framework policies, is likely to be conducive to positive adjustment. As the levels and growth of productivity, income, and employment are maximized, the demand and necessity for sector-specific intervention will be lessened, and workers and firms are more likely to be receptive to change. Hence, setting the appropriate framework policies is an important part of any overall adjustment package, since it is likely to influence the policy orientation towards the positive-adjustment end of the policy spectrum and to lessen the demand for special sectoral policies.

In the past few years, the Council has recommended major changes to framework policies in the fields of research and development, technological change, tax reform, and financial markets. In *The Bottom Line* (1983), for example, we stressed the need to not only increase the resources devoted to research and development but also give more importance to the adaptation of ideas introduced abroad and to the wider diffusion of new ideas, products, and processes already commercialized within Canada. In *Making Technology Work* (1987), we discussed ways in which technology centres can work better to improve the diffusion of new ideas. We pointed out, for example, that "successful technological change consists of a package made up of technical and human resource planning and management."

In *Road Map for Tax Reform* (1987), we recommended ways to increase the neutrality and efficiency of the tax system, thereby enabling firms and individuals to make decisions on the basis of market, not after-tax, considerations. In *Competition and Solvency: A Framework for Financial Regulation* (1986), our recommendations were designed to promote greater competition and flexibility, in order to give more scope to market decisions, while ensuring that those decisions were taken within a framework of rules designed to encourage prudence and to ensure consumer protection.

In the following paragraphs, we recall the importance of macroeconomic policies and discuss labour-market adjustment programs in some detail. These and many other framework policies must constantly be reviewed to make sure that they support, rather than thwart, adjustment.

#### *Managing the Economy*

Managing the country's economy by adopting appropriate monetary and fiscal stances is one of the most important sets of framework policies. Whether or not it is successful in providing a healthy, vibrant, and buoyant economy is an important factor in determining both the demand for intervention and the ability of governments to respond to it. When economic times are good, adjustment is greatly facilitated, as jobs are easier to find and workers are more willing to move. Furthermore, in good times, even if international competition slows the rate of increase of output and employment, it is less likely to result in actual reductions. In periods of prosperity, governments are also likely to have the funds available to aid workers in those few industries where adjustment problems are severe enough to warrant some intervention. In an economic downturn, on the other hand, difficulties in finding new jobs, combined with reluctance to move, coincide with a narrowing of governments' margin for manœuvre because of fiscal constraints.

Table 5 gives an overview of the macroeconomic conditions in Canada over the past two to three decades. All the indicators suggest that conditions significantly worsened in the 1970s and 1980s compared with the 1960s: productivity and real output growth slowed down, and unemployment rates reached, and remained at, very high levels. Despite this deterioration, we saw in Section 3 that considerable adjustment took place in the Canadian manufacturing sector in the 1970s.

In the Council's Twenty-Fourth Annual Review (1987), the indicators projected for the 1987-91 period suggest that some improvement in the underlying macroeconomic conditions is likely: unemployment is expected to average 8.5 per cent, down from 10.1 per cent in 1985-86; growth in GDP, on the other hand, is projected to average 2.8 per cent, which is somewhat below the figure for 1985-86 but above that for the early 1980s. Hence the demand for sectoral intervention, to the extent that it is driven by overall macroeconomic conditions, will probably abate somewhat.

Another series of indicators, presented in Table 6, provide a measure of the federal government's fiscal capacity to respond to any increased demands placed upon it for adjustment assistance programs. All the ratios suggest that compared with the situation in the 1960s, the federal government was subject in the 1970s and 1980s to considerable constraints on its ability to provide such assistance. While the evidence available suggests that its fiscal position will improve in the medium term, that improvement will only be

**Table 5**

**Indicators of Canada's economic performance, 1962-91**

| | Average annual GDP growth rate | Productivity[1] Level | Productivity[1] Annual growth rate | Unemployment level[2] |
|---|---|---|---|---|
| 1962-64 | 6.3 | .. | .. | .. |
| 1965-69 | 5.4 | 26,447[3] | 1.9[4] | 4.0[3] |
| 1970-74 | 5.2 | 29,242 | 2.1 | 5.8 |
| 1975-79 | 4.2 | 31,934 | 1.5 | 7.6 |
| 1980-84 | 2.3 | 32,847 | 1.1 | 9.8 |
| 1985-86 | 3.8 | 34,898 | 0.9 | 10.1 |
| 1987-91[e] | 2.8 | 35,456 | 0.6 | 8.5 |

1 Measured as real GDP per employed person, in constant 1981 dollars.
2 Persons aged 15 and over.
3 Data for 1966-69.
4 Data for 1967-69.
SOURCE Economic Council of Canada, Chart Book Data Bank Series. The data for 1987-91 are base-case projections of the Council; for details, see Economic Council of Canada, *Reaching Outward*, Twenty-Fourth Annual Review (1987).

**Table 6**

**The federal government's fiscal position: 1961-91**

| | Average annual ratios[1] to GDP of: Federal expenditures | Federal revenues | Federal deficit | Interest payments on federal debt | Federal debt |
|---|---|---|---|---|---|
| 1961-64 | 15.9 | 15.6 | –0.6 | 1.9 | 39.5 |
| 1965-69 | 15.1 | 15.9 | +0.4 | 1.8 | 29.6 |
| 1970-74 | 17.5 | 17.9 | +0.2 | 2.0 | 23.8 |
| 1975-79 | 19.5 | 16.7 | –3.0 | 2.5 | 20.6 |
| 1980-84 | 21.7 | 17.1 | –4.8 | 4.1 | 26.1 |
| 1985-86 | 23.0 | 17.4 | –5.8 | 5.3 | 36.9 |
| 1987-91[e] | 20.9 | 17.8 | –3.2 | 5.0 | 34.7 |

1 All ratios are based on data expressed in current dollars.
SOURCE Economic Council of Canada, Chart Book Data Bank Series. The data for 1987-91 are base-case projections of the Council; for more details, see Economic Council of Canada, *Reaching Outward*, Twenty-Fourth Annual Review (1987).

achieved as the result of very strict control over expenditures, reducing them from the equivalent of 23 per cent of GDP in 1985-86 to an estimated average of 20.9 per cent annually for the period 1987-91. This will foster a climate for eliminating existing programs rather than adding new ones.

This Statement is not the appropriate vehicle for recommendations regarding macroeconomic policy in Canada; but we cannot ignore its importance for adjustment. Our very brief review of the overall macroeconomic situation and of the federal government's fiscal position suggests that the resources available to finance adjustment will be greatly rationed. At the same time, the pressures of international competition highlighted in Section 1 will subject governments to continued demands for intervention in trade-sensitive industries.

*Labour Adjustment Policies*

One of the first considerations in discussing measures aimed at aiding workers adversely affected by a decline in the international competitiveness of a given industry

(caused by changes in policy or in comparative advantage) is whether a trade-related, sectoral program is appropriate. Earlier, we argued that there are grounds for targeting assistance at older workers, displaced as a result of international competition, and at those adversely affected by local labour-market congestion. We did not, however, address the related question of whether workers in the same target groups but affected for other reasons, such as technological change, should also receive assistance. An affirmative answer would suggest that a general, or framework, policy directed at all workers is more appropriate than sectoral measures reserved for those who are adversely affected by international competition.

A worker can become unemployed for a variety of reasons in a number of different situations, some of which may call for special government intervention. At first sight, there would appear to be little justification, on equity grounds, for a separate policy for workers employed in trade-sensitive industries. There is no reason to suppose that the unemployment caused by imports of Japanese automobiles is more deserving of special assistance than that caused by a decline in the demand for asbestos, now deemed by many to be a health hazard. Some people argue, however, that government has an obligation to provide assistance when hardship is the result of changes in trade policy: because it is responsible for changing the rules of the game, it should compensate those affected. But the argument for a separate policy in that particular instance is not convincing. Trade policy is only one of many government policies that adversely affect a few people but are intended to benefit society as a whole.

A second argument in favour of general, rather than sectoral, labour adjustment programs is the difficulty of isolating trade-related dislocation from that caused by other changes. As we saw in Section 3, large numbers of workers are constantly leaving their jobs and taking on new ones. Even if we were able to say what proportion of the job loss in a particular industry was related to changes in trade policy, it would be very difficult, if not impossible, to identify which of 1,000 workers laid off were specifically the victims of the resulting trade pressures. And, again, on equity grounds should society not also help those among the 1,000 who were laid off for other reasons?

Our conclusion, based on considerations of equity and administrative feasibility, is that the most appropriate way to assist workers who have been adversely affected by international competition is not through trade-related, sector-specific measures but through a more general set of labour policies. Thus,

**9 We recommend that labour adjustment policies adopted by government to assist workers in industries suffering the adverse consequences of international competition be part of general (or framework) policies designed to facilitate the adjustment of workers to changing economic times and conditions.**

Canada already has a wide variety of labour-market framework policies, many of which address the adjustment issue. The largest, in terms both of workers affected and money spent, is unemployment insurance, which in 1985 provided temporary income support amounting to more than $10 billion to 3.2 million claimants. The major objective of the Canadian Job Strategy (CJS), announced in June 1985, and of related programs is the provision of training and skill development, while a number of other programs, such as the Industrial Adjustment Service, are also designed to promote adjustment. Although we did not attempt to evaluate the adequacy of these programs, others have recently tackled this subject. The Forget Commission, for example, examined unemployment insurance; a recent Senate Committee report, *In Training, Only Work Works* (December 1987), looked at some aspects of the CJS; and with respect to the issue of on-the-job versus institutional training, a number of studies, including some by this Council, have advised placing greater emphasis on on-the-job training.

Although we are not in a position to make recommendations on the broad sweep of labour market policies, our work on a number of particular programs aimed at workers adversely affected by the pressures of international competition leads us to make three suggestions as to how these programs might be modified or improved. We also draw on other recent Council work pertinent to the labour adjustment issue.

*Preretirement Benefit Programs* — Income maintenance for older workers, in the form of preretirement benefits, has been one of the main elements of labour adjustment policies for trade-sensitive industries. The programs of the 1970s and 1980s are gradually being phased out, however, to be replaced by the Program for Older Worker Adjustment (POWA), which was announced in the 1986 Budget Papers and is of a framework nature. POWA has yet to be implemented, but some details of its design are already available. The program will be a joint federal/provincial endeavour; it will be aimed at "older workers who lose their jobs through major layoffs or plant closures and who have no immediate prospects for re-employment"; it will be triggered by "technological change, shifts in market demand, resource depletion and a variety of other factors" – in other words, by structural change. Furthermore, it would appear that POWA will not only provide income maintenance to older workers

but also attempt to encourage them to re-enter the labour force. Over the first four years, the federal government plans to allocate $125 million to POWA; as yet, however, it has not signed agreements with any of the provincial governments. While program details remain sketchy, POWA does take the existing preretirement benefit programs as its point of departure. Our examination of those programs suggests that a number of improvements could be made in their eligibility criteria.

Preretirement benefit programs are intended to provide last-resort income maintenance for older workers with a long attachment to an industry and no prospect of re-employment. There are good reasons to help such workers, as discussed above. Typically, young workers are laid off first, and older workers, last, because of their seniority. In any industry undergoing a reduction in employment, the younger workers are most mobile and have the best chance of finding another job, while the opposite is true of older workers. Hence it is socially preferable to allow contraction to proceed by encouraging the younger workers to seek employment in the growing sectors of the economy, while keeping the older workers employed in the declining industry until they are laid off according to seniority. They would thus continue to be productively employed, and their potential would not be lost to society forever.

In the early 1980s, however, changes were made in preretirement benefit programs to enable older workers to volunteer for redundancy without losing their eligibility for such benefits. In other words, if an employer has to reduce his labour force by 60 employees, he can ask older workers if they would accept layoff, even though their seniority would normally protect them. As a result, younger workers are encouraged to enter and to stay in industries adversely affected by international competition, even though it might be more useful to encourage them to go elsewhere. We suggest, therefore, that to be eligible for preretirement benefits older workers must have been involuntarily, and permanently, laid off by their employer. This suggestion represents a return to the practice that existed before 1982-83.

An important element of the preretirement benefit programs has been the designation of industries and communities eligible for benefits. For example, a community/industry designation can be made if, as a result of an industry undergoing structural adjustment across Canada, severe economic disruption occurs in a particular region. In addition, there has to be a significant loss of employment in the industry in that region. In the past, these designations were made on the basis of a memorandum to Cabinet, with no public involvement. Some communities were helped; others were not.

In view of our concern that the administration and implementation of all adjustment policies should be fair and transparent, we suggest that the criteria for determining structural change, for designating industries and/or industry/communities eligible for preretirement benefits, and for certifying layoffs be applied by an independent tribunal, with labour and employer representation and an independent chairman. Written decisions should be given. The Labour Adjustment Review Board is such a tribunal. At present, the board certifies that a worker was part of a layoff in a designated industry/community, then the Canadian Employment and Immigration Commission (CEIC) certifies that he or she has the requisite number of hours and years of service in the designated industry and is entitled to benefits equal to 60 per cent of his/her average weekly insurable earnings. Under our proposal, the board would also be responsible for designating the industries/communities.

These suggestions for consideration in the development of POWA represent modest changes to the existing preretirement benefit programs. This reflects our judgment that preretirement programs are sound in principle but have been given only limited opportunity to demonstrate their usefulness because of the adjustment-retarding impact of quotas, as well as of firm and industry subsidies. An important concern at the present time, however, is the delay in the implementation of the new program. Workers who would most likely meet the eligibility criteria are being denied access because of this delay; consequently, we urge federal and provincial governments to implement POWA as soon as possible.

*Re-employment Programs* — Canada has considerable experience in designing preretirement benefit programs but much less experience in trade-related, sectoral re-employment programs to encourage job mobility, relocation, and retraining. The major re-employment programs used to aid workers in trade-sensitive sectors, described in Figure 2, were essentially the enriched features of existing CEIC programs, supplemented by some direct job creation. Our review of the evidence suggests that direct job creation resulted in many workers requalifying for unemployment insurance, while the enriched features of existing CEIC programs seem to have had little effect in the trade-sensitive textile, clothing, and footwear industries. (It must be remembered, however, that these programs were launched during the worst recession since the Second World War.)

We have shown that there is considerable mobility of labour in Canada between occupations, regions, and employers, even in trade-sensitive industries. This does not mean, of course, that people in trade-sensitive industries do

not have re-employment problems that require assistance. It is important, however, to make sure that the assistance provided responds to the observed needs of that segment of the labour force.

One prevalent characteristic of some of the most important trade-sensitive industries is that worker education is low, by general manufacturing standards, and the jobs are unskilled. For example, 76 per cent of the workers in Ford's automobile assembly plants in Canada are in unskilled jobs (defined as those requiring less than 30 days' training to be proficient on the job). In 1981, the percentage of the labour force with less than Grade 9 education was much higher in the textile, leather, knitting, and clothing industries – ranging from 26 per cent to 39 per cent – than in all of manufacturing, where it was only 19 per cent. Furthermore, this lack of formal education is particularly prevalent in the clothing industry – by far the largest employer of the four industries – where the labour force consists largely of women.

Canada is unlikely to have a competitive advantage in industries characterized by low levels of formal education and unskilled tasks. Underdeveloped and newly industrialized countries (NICs) have large supplies of labour with such characteristics. Furthermore, even in industries requiring considerable capital investment (such as the automobile industries), some of the NICs (South Korea, for example) pose a competitive challenge to Canadian producers. This does not mean that trade-sensitive sectors cannot revitalize themselves, using a more skilled work force. Nevertheless, job growth in Canada is likely to be in sectors requiring more highly skilled labour, so it is important that workers be given the opportunity to upgrade their skills and their educational attainment.

As we pointed out in *Making Technology Work*, the need for skill upgrading is not confined to trade-sensitive industries. In that report, we made a number of suggestions for achieving a well-trained, flexible, and committed labour force. These included support for employer-based training in selected highly skilled occupations, the creation of conditions conducive to continuous learning on the job, and the provision of funds and leave for training. The central principles of our proposed policy framework for worker retraining were:

- private-sector initiative in making training choices;
- support for joint employer/employee solutions;
- concern for those disadvantaged in the labour force;
- flexibility in program design and administration; and
- decentralized decision making.

These principles are consistent with the general orientation of positive-adjustment policies, particularly in encouraging workers and employers to make their own decisions about training. Regarding government funding for labour training, we suggested in *Making Technology Work* not an increase but a re-allocation of funds, with a view to providing "an environment within which employers and workers can make informed decisions about necessary retooling and can then carry out the required training." This suggestion, which we continue to believe would pay high dividends, is also supportive of positive adjustment.

*Consultative Mechanisms* — In Section 2, we noted that the worker's access to information about job opportunities (except at the local level) is much more restricted than the investor's or the firm's access to information on market conditions. The individual is much less likely to be aware of all the government programs that offer opportunities for job creation, training, or employment than is the firm with respect to government programs that offer financial assistance. We also noted that in local labour markets, a major plant closure necessarily has a severe impact on employment opportunities. Thus there is a role for government not only in providing such information to individuals but also in actively facilitating the adjustment process for workers.

This role is undertaken by the Industrial Adjustment Service (IAS), whose objective is "to encourage employers and their employees to work together to reduce current and expected labour adjustment problems within their establishments . . . and, through human resource planning, to obtain or provide an appropriate workforce in the future." Management and labour will often approach the IAS when labour adjustment problems are anticipated – a plant shutdown, for example. Shutdowns frequently require advance notification by law, so that the IAS may be called in before the anticipated layoff takes place. Management and labour form joint consultative committees to "analyze the labour adjustment problems, develop solutions to them and oversee the implementation of the solutions." The IAS offers financial assistance to set up the joint consultative committee and provides details of the full range of CEIC and Labour Canada programs. A number of studies have given the IAS program high marks; as we noted in *Making Technology Work*, it "has proven to be a fast, flexible, and cost-effective method of promoting adjustment." It should be noted that this flexibility applies not only to plant closures but also to plant start-ups.

In a typical year, between 4 and 5 million Canadians, or one-fifth of the working-age population, lose or leave their jobs. As we saw in Section 3, many workers decide to change jobs on their own initiative, but a considerable part

of the turnover is firm-initiated and leads to permanent layoffs. The number of workers currently assisted by the IAS is much smaller than the number of those laid off, so there are probably other workers who could benefit from its services. Accordingly, we suggest that government make every attempt to make workers and employers aware of the availability, functioning, and purpose of the Industrial Adjustment Service. Major plant shutdowns are traumatic events, frequently leading people to use CEIC services and to draw unemployment insurance benefits for the first time. The IAS offers a way of smoothing the transition and facilitating re-employment. It should be strongly supported.

### *Conclusion*

We realize that Canada cannot avoid adjusting manufacturing operations to the harsh pressures of international competition. The challenge is to manage that adjustment wisely. We see a legitimate and important role for government intervention at two distinct levels: the setting-out of framework policies in areas such as taxation, competition, and labour markets; and the designing of selected sectoral policies to help specific industries cope with adjustment. But we consider sectoral policies as exceptions, to be introduced only under particular conditions and subject to clear evaluation.

It is important to recognize that Canadians have demonstrated a considerable capacity to adjust. Our research shows that they frequently change not only jobs but occupations and industries. One role for government, therefore, is to encourage necessary change by helping workers to acquire new skills through training and by creating a safety net (through unemployment insurance, for example) to cushion the income losses associated with involuntary job change.

Our research also shows that firms are constantly engaged in a process of adaptation – contracting or expanding production and employment, entering or exiting industries, merging and divesting, building new plants and closing existing plants. Furthermore, using a number of indicators of firm adjustment (such as firm exit rates via plant closures), we find that the industries most sensitive to international competition perform in much the same way as other manufacturing industries. In addition, we find that foreign-owned firms often respond to international competition in much the same way as Canadian firms. Where differences do arise, however, the presence of foreign-owned firms appears to enhance, rather than diminish, the ability of the Canadian manufacturing sector to adjust to the pressures of change. Accordingly, we see no need for adjustment policies that differentiate between Canadian and foreign-owned firms.

While we are critical of the way the federal government's sectoral programs have been implemented in the past, the objectives of those programs have largely been on the side of positive adjustment. That is, they have been designed to promote adjustment by encouraging manufacturers to renew their product line and upgrade their production systems. They have also frequently provided a breathing space during which the firm could leave the industry in an orderly fashion.

The problem is that there is a large gap between the rhetoric of policy objectives and the reality of program implementation. The programs themselves have, more often than not, discouraged adjustment. They are therefore examples of the new protectionism. We do not see that outcome as either inevitable or predetermined by the Canadian political system. There is an alternative approach that is both more open and more judicious in the use of resources.

To make the actual program implementation more congruent with the objective of positive adjustment, we have put forward nine principles. These principles call for more open and thorough evaluation of the policy options, with emphasis on labour market policies rather than on assistance to firms to modernize capital equipment. We also set out guidelines for the proper allocation of quantitative restraints on imports.

The use of these principles will help governments to manage the adjustment process in a way that is attuned to the hardship created by competitive pressures; targeted at improving the competitive performance of manufacturers; and, at the same time, alive to the interests of consumers, workers, and employers.

## Comments

*Raymond Koskie*

I concur with the general thrust of the Council's Statement. The approach based on establishing adjustment policies to compensate for trade-induced economic displacement that are directed at affected employees rather than affected businesses, is sensible, particularly if trade-related displacement is limited, the general economy is buoyant, and unemployment is low. However, where trade-induced dislocations are substantial or the general economy is weak, I believe that sectoral policies may be required.

Similarly, if the economy is exposed to a serious trade "shock" because of the Canada-U.S. Free-Trade Agreement, the proposals contained in the Council's Statement may not be adequate. The problem is exacerbated by the apparent refusal of the federal government to release its studies and supporting material on the impact the Agreement will have on jobs. Logic suggests that if the studies demonstrated a minimal effect in terms of job losses, they would already have been released. One can assume, therefore, that the studies show otherwise, which causes me great concern. That being the case, it is at best premature, in my view, for the Council to suggest, for example, that additional government funding will not be required for labour training. The government should be encouraged to be more forthright and to release these studies so that a proper and fair assessment of the deal can be made. Otherwise, there is a vital missing link in the chain.

It is not sufficient for the government of the day to continue to embrace the Council's predictions of job gains and losses, particularly when the econometric basis for this has many inherent flaws, as indeed many econometric models have. Due to unknown human responses, it is difficult, if not impossible, for econometric models to predict:

- whether and how businesses and workers can increase productivity;

- whether businesses will specialize in certain goods and services;

- whether businesses will invest in modern technology; and

- how much interest rates, exchange rates, and oil prices will fluctuate.

Surely, it is in the best public interest for the government to release these studies now.

The Council's discussion on multinational enterprises in Canada neither mentions nor comments upon certain data prepared by Statistics Canada for the Council of Canadians (opponents of the Free-Trade Agreement). In my view, a full assessment of how multinational enterprises operating in Canada will respond to the Agreement is not complete without an examination of these statistics.

The Statistics Canada data (see table) demonstrate that foreign-owned enterprises had a substantially negative impact on employment in Canada between 1978 and 1985. As these data show, large American-owned enterprises shed 50 per cent more employees than their Canadian counterparts between 1978 and 1985. Large Canadian enterprises suffered a net decline of 8.6 per cent in employment, whereas large U.S. companies suffered a 12.8 per cent employment decline during this period. Similarly, medium-sized American-controlled companies reduced their work forces by 4.3 per cent between 1978 and 1985, whereas medium-sized Canadian-controlled enterprises only reduced their work force by 2.9 per cent between the same years. Small Canadian-controlled enterprises created 209,700 jobs in Canada between 1978 and 1985, whereas small U.S.-controlled enterprises created only 8,200 jobs.

These substantially greater rates of employment decline in American-controlled medium- and large-sized companies, and the vastly superior job creation performance of Canadian-controlled small companies over their American-controlled counterparts, amply demonstrate that Canadian ownership corresponds to higher employment in Canada. These data, therefore, have important implications for trade and investment liberalization which have not been commented upon by the Council.

Finally, I feel obliged to comment upon Recommendation 5 of the Council, namely: "We recommend that the policy evaluation proposed in Recommendation 4 be undertaken by an independent arm's-length tribunal, whose mandate is not confined to one or a small number of industries."

**Employment growth versus company size in goods-producing industries: Job creation, 1978-85**

| | Small – less than 20 jobs | | | Medium – 20 to 99 jobs | | | Large – 100 plus jobs | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Employment, 1978 | Net change, 1978-85 | | Employment, 1978 | Net change, 1978-85 | | Employment, 1978 | Net change, 1978-85 | | All sizes, 7-year change |
| | | Numbers | Rate | | Numbers | Rate | | Numbers | Rate | |
| Country of control: | (Thousands) | | (Per cent) | (Thousands) | | (Per cent) | (Thousands) | | (Per cent) | (Thousands) |
| Canada | 399.9 | +209.7 | +52.5 | 423.2 | –12.3 | –2.9 | 1,106.4 | –94.8 | –8.6 | +102.6 |
| United States | 4.6 | +8.2 | +178.0 | 32.9 | –1.4 | –4.3 | 528.1 | –67.8 | –12.8 | –61.0 |
| Other foreign | 1.9 | +2.7 | +142.0 | 14.7 | –1.1 | –7.5 | 184.0 | –27.0 | –14.7 | –25.4 |
| Total | 406.5 | +220.6 | +54.3 | 470.8 | –14.8 | –3.1 | 1,818.5 | –189.5 | –10.4 | +16.2 |

SOURCE Data from Statistics Canada, October 1987.

The Statement goes on to give preference to the Canadian Import Tribunal over more specialized tribunals or boards that would deal with the problems of specific industries, such as, for example, the Textile and Clothing Board. In my view, this Board has made a significant and substantial contribution towards resolving the textile and clothing industry's problems. This is attributable in part to the expertise and experience of that specialized Board. Similar specialized boards for other industries can also be expected to make a valuable contribution in their sectors.

Until such time as adequate framework policies are in place, approaches to trade-induced sectoral crises, such as those which have been recommended by the Textile and Clothing Board, seem to me to be both commendable and necessary.

## Background Studies Commissioned by the Council

| | |
|---|---|
| J. Ahmad | Trade-related, sector-specific industrial adjustment policies in Canada: An analysis of the textile, clothing and footwear industries |
| J. R. Baldwin and P. K. Gorecki | Structural change and the adjustment process |
| K.E.A. de Silva | The Pulp and Paper Modernization Grants Program: An assessment |
| _____. | An economic analysis of the Shipbuilding Industry Assistance Program |
| S. Globerman | The impacts of trade liberalization on imperfectly competitive industries: A review of the theory and evidence |
| D. MacMillan | Adjustment and government policy towards the Canadian automobile assembly industry |
| D. McFetridge | Trade liberalization and the multinationals |
| B.-M. Papillon | The Bankruptcy Law and economic adjustment |
| M. Trebilcock and M. Chandler | Adjusting to trade: A comparative perspective |

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